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Report to the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, Committee on Government Operations, House of Representatives

EUROPEAN COMMUNITY

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U.S. Financial Services' Competitiveness Under the Single Market Program

GAO

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National Security and
International Affairs Division

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May 21, 1990

The Honorable Doug Barnard, Jr.
Chairman, Subcommittee on Commerce,
Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we assess how the European Community's (EC) Single Market Program might affect U.S. financial firms. It examines the extent to which U.S. financial firms participate in EC markets, the potential opportunities and challenges presented by changes in the Community, and how U.S. government agencies are working to assure full and fair access to European markets.

As agreed with your office, we did not obtain formal agency comments on this report. As also agreed with your office, we plan no further distribution of this report until it is released at a hearing of your Subcommittee on May 23, 1990. At that time, we will send copies to the Secretary of the Treasury, the Secretary of State, the Secretary of Commerce, and the United States Trade Representative. We will also make copies available to others upon request.

This report was prepared under the direction of Allan I. Mendelowitz, Director, International Trade, Energy, and Finance Issues, who may be reached on (202) 275-4812. Other major contributors are listed in appendix II.

Sincerely yours,

Frank C Conahan

Frank C. Conahan
Assistant Comptroller General

Executive Summary

Purpose

The European Community of 12 nations plans to create a single European market by 1992. The Chairman of the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, asked GAO to assess how the Community's Single Market Program might affect U.S. financial firms. This report examines the extent to which U.S. financial firms participate in European Community markets, the potential opportunities and challenges presented by changes in the Community, and the efforts of U.S. government agencies to assure full and fair access to European markets.

Background

The Community envisions a single, integrated market characterized by the unrestricted movement of people, capital, goods, and services across its member states' borders. The Community aims to complete this program by the end of 1992. However, some steps towards unification have already occurred, while others will not be completed for some time.

Results in Brief

New opportunities exist for U.S. financial firms to expand their considerable business in the European Community. At the present time, U.S. firms should face relatively few Community-imposed restrictions. This openness is due, in part, to U.S. government agencies' actions, which made U.S. interests known to the Community.

New powers and market access granted by the 1992 program will particularly affect retail (consumer) markets, and any financial firm with a presence in the Community could benefit from the increased demand for financial services.

Many U.S. financial firms, however, do not plan to expand beyond their existing wholesale (commercial and interbank) operations. Factors such as the burden of meeting increased capital adequacy standards for banks and the problem of allocating limited capital among competing investment alternatives will drive their decisions.

In addition, some U.S. financial firms, notably banks, contend that U.S. laws and regulations on certain activities impose serious obstacles to expansion. These restrict the kinds and amount of business U.S. financial firms may conduct, potentially putting them at a disadvantage to European competitors.

Principal Findings

U.S. Participation

U.S. financial firms have a considerable stake in their Community operations, particularly in Community wholesale markets. U.S. banks are active in every Community country, holding over $200 billion, or 5 percent, of total Community bank assets among their hundreds of branches and subsidiaries. U.S. securities houses rank among the world's largest in their Euromarket activities. While only a few U.S. insurance companies operate in the Community, the 1992 program has sparked renewed interest.

U.S. financial firms no longer fear that the Community's Single Market Program will deny them access or limit participation in Community financial markets. U.S. government, private sector, and media concern over "reciprocity" provisions in draft Community legislation has largely faded in the last year, though protectionism could resurface at any time.

Opportunities

The formation of a unified financial market in Europe offers many new opportunities and benefits for financial institutions and Community consumers. The Community will rival Japan and the United States as one of the world's largest markets, with 325 million people, a gross national product of $4 trillion, $3.9 trillion traded annually on bond and equity markets, and an insurance market that accounts for roughly a quarter of world premiums.

The European Community's Single Market Program is a part of the deregulation of Community member states' domestic financial markets, that should enable institutions to consolidate operations and offer more products. Firms offering investment services should also benefit from increased corporate financial activity, such as expansions, restructuring, and mergers and acquisitions.

Factors Limiting U.S. Participation

In general, U.S. financial firms do not plan to expand their presence or activities in the Community. Many U.S. banks, for example, are constrained by capital limitations. Relaxation of interstate banking restrictions in the United States has created opportunities for banks to expand domestically, and many banks view such expansion as a better use of their capital. U.S. banks are particularly concerned that legal limits on the mixing of banking and securities activities in the United States and

regulatory limits on their overseas securities activities put them at a competitive disadvantage compared to Community firms that can offer both kinds of services under the Community's universal banking model. For further discussion of U.S. banking laws and regulations, see Bank Powers: Issues Related to Repeal of the Glass-Steagall Act (GAO/GGD-88-37, Jan. 22, 1988).

U.S. Government Activities

The U.S. government has responded in a timely fashion to protect U.S. financial sector interests in the emerging European Community single market. This action was most evident and important in the response to a restrictive "reciprocity" provision in an early version of a Community banking directive. The U.S. government's response was one of several factors that led the Community to soften its stance.

Matters for Congressional Consideration

The Community's endorsement of the universal banking model for its more open financial markets gives greater urgency to the ongoing congressional debate over how broad U.S. bank powers should be. The decision to modify the existing regulatory requirements is a judgmental one. In weighing the pros and cons of the existing structure, consideration should be given to the impact of these requirements on the ability of U.S. banks to compete in the Community after 1992.

Agency Comments

As requested, GAO did not obtain official comments on a draft of this report. The views of responsible officials were obtained during GAO's work and are incorporated in the report where appropriate.

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Abbreviations

EC	European Community
ECU	European Currency Unit
EMS	European Monetary System
EMU	Economic and Monetary Union
GAO	General Accounting Office
GATT	General Agreement on Tariffs and Trade
OECD	Organization for Economic Cooperation and Development
UCITS	Undertakings for Collective Investment in Transferrable Securities

Chapter 1

The European Community's Single Market Program

The European Community (EC) has embarked upon a plan to create a single European market characterized by the unrestricted flow of goods, persons, services, and capital. The EC's objective is to create a more efficient European economy with lower prices, higher wages, and greater productivity. This goal will be accomplished through a series of legislative steps removing existing technical, fiscal, and physical barriers. Most of these steps are to take effect by January 1, 1993, hence the popular name "EC 1992." Key to this process are the integration and liberalization of the EC's financial services sector because of its leading and far-ranging effect on other sectors.[1]

Basis for the Single Market Program

The Treaty of Rome, signed in 1957, signaled the beginning of European economic integration. By establishing a common market, the EC intended to bring the economic policies of member states closer together. The treaty called for the free movement of goods, persons, services, and capital within the Community but did not establish a framework to achieve it. The treaty initially focused on providing the grounds to eliminate tariff barriers and promote tax harmonization. The creation of the European Monetary System (EMS)[2] in 1979 helped stabilize Community exchange rates and paved the way toward future cooperation.

Despite these steps toward integration, many internal barriers remained. Many Europeans believed that relatively slow European economic recovery from the global recession of the 1970s was, in part, caused by multiple trade barriers and overly protected markets. The EC's dependence on world trade and the increasing internationalization of world economies also added impetus to the EC's plan to unify its markets.

The EC's Single Market Program was formally launched in 1985 with the EC's White Paper "Completing the Internal Market." This paper identified barriers, proposed a series of 300 measures (later reduced to 279) necessary to abolish them, and set forth a regulatory framework to

[1]For an assessment of how the Single Market Program may affect U.S. small and medium-sized merchandise exporters, see European Single Market: Issues of Concern to Exporters (GAO/NSIAD-90-60, Feb. 13, 1990).

[2]The EMS established a new currency, the European Currency Unit (ECU), which is a basket of European currencies consisting of specified amounts of the currencies of 10 of the 12 member states. The 12 member states include Belgium, Denmark, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, the United Kingdom, and West Germany. The EMS also employs an exchange rate mechanism that limits to certain defined bands the variance between member states' currency exchange rates.

achieve a single European market. Most of these measures are in the form of directives.[3]

The White Paper set a timetable for enactment of each measure and required the entire program to be in place by the end of 1992. Once a directive is adopted, member states are typically given 2 years to conform their national laws to it. Thus, to complete the internal market by the end of 1992, most of the directives would have to be adopted by the end of 1990.

The Single European Act of 1987 reaffirmed the White Paper's objectives and accelerated the market integration process. It changed the way EC legislation is passed for most Single Market Program initiatives by requiring only a weighted majority of member states to approve the adoption of a proposed directive.[4] Previously, unanimity was required, and one member state could block legislation. The act also established greater consultation among the various EC institutions during the legislative process.

EC Institutions

The European Community consists of four supranational institutions: the EC Commission; the Council of Ministers; the European Parliament; and the European Court of Justice. The EC Commission is the executive branch: it drafts and proposes legislation and enforces the implementation of Community law. The Commission, while representative of the various member states, is largely nonpartisan. This arrangement contrasts with the Council of Ministers, the EC's main decision-making body, which represents the views of individual member states. The Council consists of ad hoc groupings of cabinet-level officials from the member states, e.g., for the financial services sector, the Council consists of the finance ministers of each member state. Legislation proposed by the Commission must be approved by the Council before it becomes law. The European Parliament is more populist than the other bodies, as representatives of this body are directly elected by Community citizens. While the Parliament has limited legislative power because it cannot initiate or enact legislation by itself, it can make amendments to proposed directives; as a result, the Council and Commission are sensitive to the

[3]An EC directive requires member states to ensure that their national regulation conforms to the directive's objectives but leaves them free to decide how it should be implemented. EC regulations, on the other hand, are used more sparingly and supersede existing national law.

[4]Known as "qualified majority voting," voting weights are assigned to each state loosely according to its population and economic power. Social and tax matters still require unanimous approval under the Single Market Program.

Parliament's concerns. The European Court of Justice ensures that EC legislation is interpreted and applied according to the principles of EC law. As the Single Market Program progresses, the Court of Justice will play an increasingly important role in interpreting and enforcing Community law.

The Single Market's Law-Making Process

Under the Single European Act, the EC follows a more complex and more consultative process in enacting legislation than it did before. In this process, known as the Cooperation Procedure, a Commission proposal must pass through a number of steps before enactment. As it proceeds through the steps, a measure is affected by a host of internal and external influences and can change substantially. The Cooperation Procedure essentially operates as patterned in figure 1:1. (see pages 12 and 13)

Economic and Monetary Union (EMU)

The single market in financial services is one step toward a longer-term EC goal of greater unification of monetary and fiscal policy. In 1989, the President of the Commission, Jacques Delors, released a report proposing three stages for achieving an Economic and Monetary Union. The EMU goes beyond the Single Market Program in proposing fixed exchange rates among national currencies and the eventual creation of a single European currency and central bank.[5] At the European Community's Madrid Economic Summit in June 1989, leaders of the 12 EC nations agreed to an intergovernmental conference to amend the Treaty of Rome and to begin the first stage of the EMU process on July 1, 1990.

[5]The Delors Committee report proposes a three-stage process toward EMU.

(1) Greater EC member state coordination of economic and monetary policy, requiring all members to join the EMS.

(2) A transitional phase, establishing an institutional framework to set economic objectives and budget deficit limits for member states. This step includes setting up a European system of central banks similar to the U.S. Federal Reserve System.

(3) Locking exchange rates and instituting rules on macroeconomic and budgetary policy. This step requires establishing one central bank to make EC-wide monetary policy and creating a single European currency.

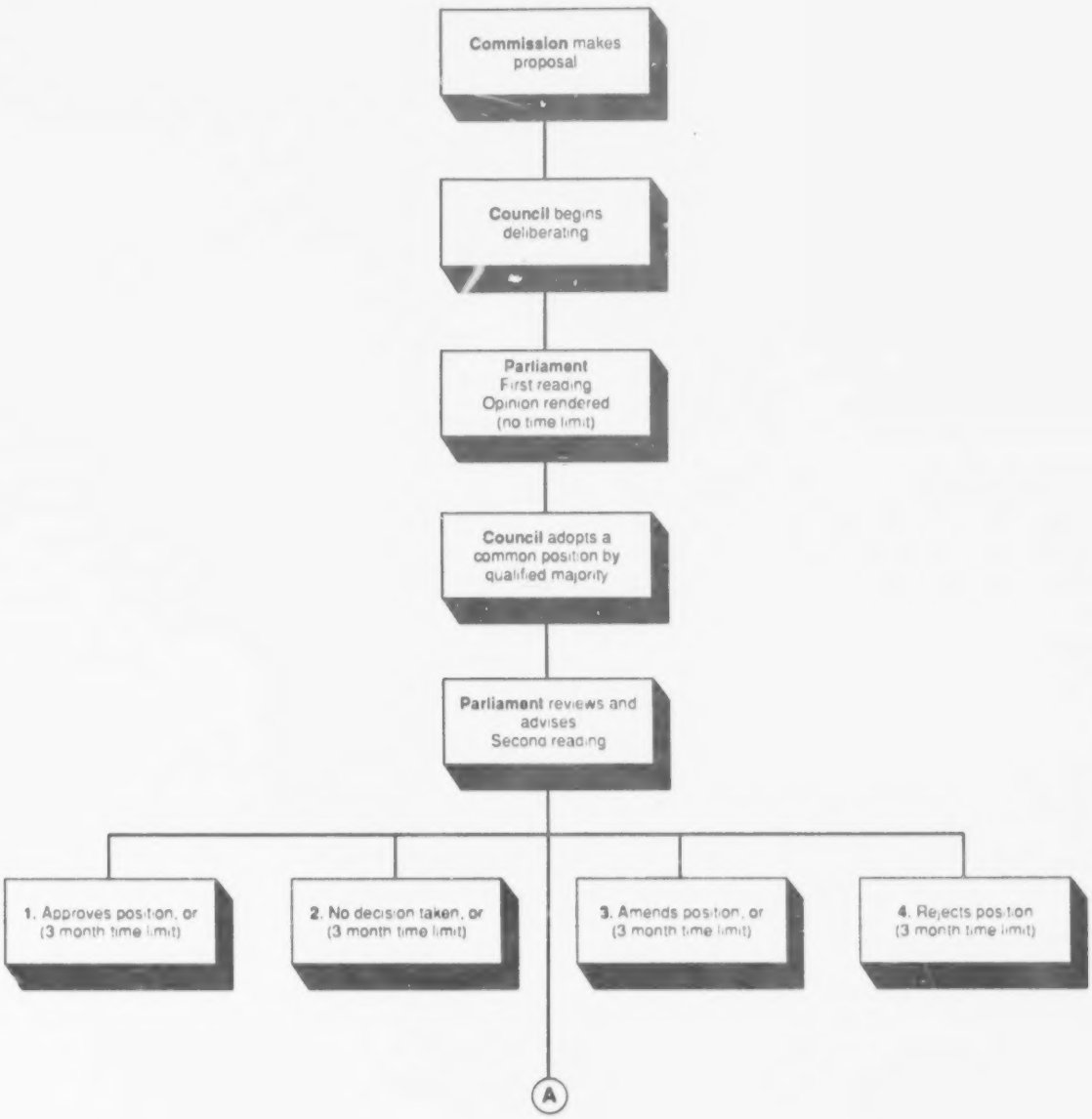
The Single Market Framework for Financial Services

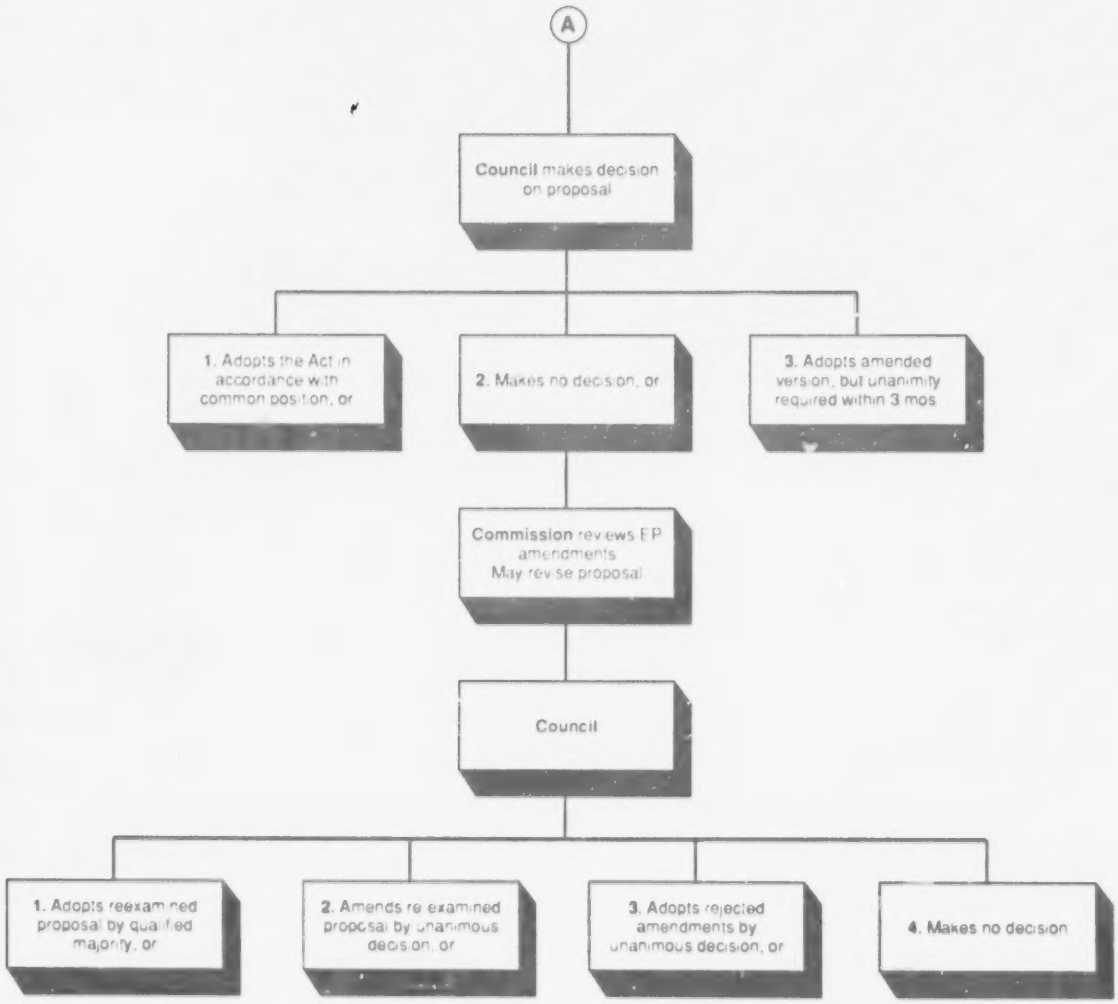
The Single Market Program emphasizes (1) the unrestricted movement of capital within the Community, (2) the goal of eventual freedom for financial firms to operate throughout the Community under the same set of regulations, and (3) the use of reciprocity to open other countries' markets to EC firms. The EC's aim is to provide enough financial regulation to ensure banks' safety and soundness while at the same time allowing flexibility and not imposing overly burdensome regulation.

Unrestricted Movement of Capital

A single market for financial services would not be possible without the unrestricted flow of capital among nations. Free capital movement means that a resident of one EC member country can use the financial services of any other member state, including banking, stock exchange, and real estate markets. This freedom allows capital, whether intended for savings or investment, to move to the most efficient and competitive marketplace. The EC seeks to achieve this freedom by removing currency exchange controls and other discriminatory barriers on capital transfers and their underlying transactions (i.e., trade in goods or provision of services) and by abolishing discriminatory measures such as taxation of certain investors.

Figure 1.1: The EC's Cooperation Procedure


Commission makes proposal
Council begins deliberating
Parliament First reading Opinion rendered (no time limit)
Council adopts a common position by qualified majority
Parliament reviews and advises Second reading
1. Approves position, or (3 month time limit)
2. No decision taken, or (3 month time limit)
3. Amends position, or (3 month time limit)
4. Rejects position (3 month time limit)
A


A
Council makes decision on proposal
1. Adopts the Act in accordance with common position, or
2. Makes no decision, or
3. Adopts amended version, but unanimity required within 3 mos
Commission reviews EP amendments May revise proposal
Council
1. Adopts reexamined proposal by qualified majority, or
2. Amends re examined proposal by unanimous decision, or
3. Adopts rejected amendments by unanimous decision, or
4. Makes no decision

Single Passport for Financial Services

Central to the liberalization of financial services under the Single Market Program is the concept of a "single passport." Once a financial firm is established and licensed in one member state, its home country, that firm can use a single passport to offer financial services in any other member state, or host country. With a single passport, a firm is free to render its services anywhere in the Community, either directly across borders or through branches. In turn, consumers of financial services will be able to select the institutions offering the lowest cost and best services regardless of where they live.

Mutual Recognition

The EC has specified a minimum level of regulation, beyond which countries are free to regulate their markets as they see fit. Known as "mutual recognition," this element requires a minimum level of harmonization, or essential equivalence, to ensure the safety and soundness of the financial system. For instance, the Second Banking Directive requires all EC banks to have a minimum capital base, a minimum level of shareholder disclosure, and a maximum limit on the degree of equity participation in nonfinancial firms.

Mutual recognition also entails home country control, i.e., a financial firm has the same powers and is subject to the same home country supervision and regulatory limits regardless of where its services are rendered under the single passport. In general, a host country only has authority to supervise branch liquidity or marketing-related activities. Mutual recognition has important ramifications because regulation can vary between countries. If a home country's rules are more liberal than those in host countries, its financial firms will be able to offer a wider range of services and will not be subject to the same regulatory costs as would the host countries' own financial firms. The expected result under competitive circumstances will be that member states' regulation will all eventually converge to the same minimum essential standards and the widest range of permissible powers. This process is known as "regulatory convergence."

Perhaps the best example of the impact of regulatory convergence will be in the banking sector. The EC's Second Banking Directive allows banks a broad range of permissible powers, including participating in securities-related activities, based on the universal banking tradition[6] found in some EC countries. It is fully expected that those member states that do not currently follow a universal banking concept will eventually

[6]Universal banks perform both banking and securities-related activities.

permit broader bank powers so that their domestic banks are not placed at a competitive disadvantage vis-a-vis other EC banks operating in their country.

Reciprocity

The EC's application of reciprocity for financial services has evolved from a protectionist and potentially mutually restrictive form to one that is liberal. The original provision introduced in the Second Banking Directive of early 1988 appeared to seek identical, or mirror-image reciprocity, that is, U.S.-owned bank subsidiaries in EC markets would be permitted only those activities granted to EC-owned banks in the United States. This provision was one of the primary reasons the United States feared the rise of a protectionist EC, or "Fortress Europe." The EC, however, reasoned that in a financially interdependent international environment, its financial firms should enjoy fair access and equivalent treatment in other world markets.

Further fears arose, owing to the ambiguity of the reciprocity language in the banking directive and its interpretation by a prominent member of the Commission. That member reasoned that reciprocity could be imposed retroactively, i.e., non-EC banks already in the EC would not be "grandfathered" or allowed to do business in accordance with the new law. Non-EC firms were also concerned about the automatic review procedures outlined in the provision, which required automatic suspension of applications from all non-EC financial institutions pending reciprocity review by the Commission. These firms feared this requirement would delay and impede their ability to enter the EC, acquire other financial institutions, or restructure their businesses in the EC.

But the Council of Ministers adopted new language in the Second Banking Directive on December 15, 1989. The new language provided a substantially revised and more liberal reciprocity provision to be effective in 1993. The EC intends to seek reciprocal national treatment with effective market access. This goal means that U.S. banks would be granted the same opportunities in the EC as EC banks are granted, as long as EC banks are not discriminated against in the United States. The automatic review procedure was eliminated. If the EC determined that EC banks are

not treated equally in the United States, then the EC would seek negotiations.[7]

The reciprocity provision in the Second Banking Directive has received much attention, in part because the EC has stated that the form reciprocity takes in the banking sector will be used as the model for treating investment services and insurance as well.

Financial Services Directives

Of the approximately 30 directives relevant to the Single Market Program's financial services area, the 9 discussed in this section are key to the program and are critical in understanding its impact on U.S. financial firms. They are intended to integrate EC markets and open them to competition. For the status of these and other EC 1992 directives, see appendix I.

Second Banking Directive

The Second Banking Directive establishes the key principles upon which the EC bases its regulatory framework: a single banking license, home country control with mutual recognition, and reciprocal national treatment.

The single banking license allows any bank authorized in one member state to provide a broad array of financial services,[8] similar to those conducted by universal banks, in any other member state. Non-EC banks are also eligible for the single banking license, as long as they incorporate an EC subsidiary in any one of the member states.

EC banks' activities outside their home country will be subject to supervision and regulation by their home country. The primary exceptions to

[7]According to the current proposal, 6 months before the directive is implemented on January 1, 1993, the Commission will draft a report examining the treatment given to EC banks in third countries. In those circumstances where EC banks are not afforded effective market access comparable to that granted by the EC to credit institutions from a foreign country, the Commission may submit a proposal to the Council for negotiations to seek comparable competitive opportunities. In those instances where EC banks do not receive national treatment, the Commission may initiate negotiations to remedy the situation.

[8]The list of permitted activities under the single banking license are (1) deposit taking and other forms of borrowing, (2) lending, (3) financial leasing, (4) money transmission services, (5) issuing and administering means of payment (credit cards, travellers checks), (6) guarantees and commitments, (7) trading for their own or customers' accounts in money market instruments, foreign exchange, financial futures and options, exchange and interest rate instruments, and securities, (8) participation in share issues and the provision of services related to such issues (i.e., underwriting), (9) money brokering, (10) portfolio management and advice, (11) safekeeping of securities, (12) credit reference services, and (13) safe custody.

home country control are conduct of business rules and control of monetary policy. Supervisory authorities in the host country will retain primary oversight over branch liquidity and exclusive responsibility for monetary policy. The host country will also have authority over marketing of services within its boundary. Finally, the host country could apply additional restrictions, but only in rare circumstances affecting the public interest.

Capital Adequacy Directives

The Commission proposed two directives dealing with capital adequacy for banks: the Own Funds Directive, which defines qualifying capital; and the Solvency Ratio Directive, which determines the quantity of the qualifying capital that is required. The Council adopted the former on April 17, 1989, and the latter on December 18, 1989. Both of these directives are to be implemented in conjunction with the Second Banking Directive on January 1, 1993.

Investment Services Directive

The proposed Investment Services Directive is structured very similarly to the Second Banking Directive, but applies to nonbank financial firms not covered by the banking directive. The directive is based on the same principles as the Second Banking Directive regarding a single passport, mutual recognition, and home country control.

The EC intends to implement its directive at the same time as the Second Banking Directive, so that there is no period during which investment firms will be at a competitive disadvantage to banks. However, member states that do not have domestic investment service firms (i.e., if these services are provided by universal banks) may not be as eager to press for timely passage of the Investment Services Directive.

Under the proposed Investment Services Directive, EC investment firms, like banks, will be free to open branches or to offer their services across borders to any other member state, subject to the same set of regulations as they would be under home country control. The single passport gives any EC-authorized firm access to member state stock exchanges. The host country retains control for conduct of business rules and compensation methods to protect investors in case of investment firms' default or bankruptcy.

The directive lists permissible activities in which these firms may engage and instruments that they may sell.[9] Competitive pressures will force regulatory convergence; thus, those countries that currently do not permit some of these activities are likely to broaden permissible powers.

The proposed directive still contains the original and restrictive reciprocity language that first appeared in the banking directive. However, the EC promises that the directive will be revised by the Commission in line with the current reciprocity provision in the banking directive.

The EC said it intends to introduce another directive addressing capital adequacy provisions for investment firms. However, there is a lack of agreement on a basis for assessing capital adequacy standards for investment firms.[10]

UCITS Directive

The principal directive concerning funds management is the Directive on Undertakings for Collective Investments in Transferrable Securities (UCITS). These undertakings are more commonly known in the United States as mutual funds. Under the UCITS Directive, once a fund is authorized in an EC home country, it can be freely sold throughout the remainder of the Community. The directive applies to both unit trusts and investment companies. It was adopted by the EC in December 1985 and implemented by most member states on October 1, 1989 (Greece and Portugal have until April 1992 to implement it).

Insurance Directives

Both life and non-life insurance companies had the freedom to conduct business in the EC long before the Single Market Program was initiated in 1985.[11] But this freedom, unlike banking and investment services, has

[9]Permitted activities include brokerage; dealing as principal; market making; portfolio management; arranging and underwriting transferrable securities; investment advising; and safekeeping and administration. Salable instruments include transferrable securities; money market instruments; financial futures and options; and exchange rate and interest rate instruments.

[10]British, U.S., and Japanese regulators propose that base capital requirements be held to a minimum, but subject to close scrutiny and continual adjustments based on market value of security provisions and other factors. German regulators take the opposite tack, pushing for a much larger base capital requirement (as German banks have) but greater freedom to conduct their activities.

[11]Life insurance includes whole, unit, and term life policies. Non-life includes insurance against accident, sickness, damage to and loss of property, liability (e.g., motor vehicle), credit, and suretyship. Under 1964 and 1978 EC directives, firms active in reinsurance and coinsurance markets already enjoy freedom of establishment and provision of cross-border services within the EC.

always been subject to authorization by the host country. The Commission now wants to apply the single passport concept to insurance services.

The EC has achieved greater progress in liberalizing non-life insurance than in liberalizing life insurance. The First Non-Life Insurance Directive, implemented in 1973, coordinated member states' laws governing the establishment of insurance businesses. The directive covers how insurance firms should be legally formed; what the supervision and cooperation among states should be; what the restrictions on providing insurance should be; what the rules on fiscal soundness should be; and what the procedures for setting up branches and subsidiaries throughout the EC should be.

The Second Non-Life Insurance Directive, scheduled to be implemented on June 30, 1990, expands upon the first by establishing specific rules on the provision of cross-border insurance services. However, unlike the banking and investment services directives, home country control is only applicable to wholesale customers, or to large risks.[12] The host country still supervises non-life insurance services provided to individuals, known as mass risks.

As for life insurance, a directive allowing freedom of establishment was adopted in 1979, but there have been no proposals as yet on provision of services. A key EC official told us that once capital movement is unrestricted and alternative savings and investment vehicles are available, it will become increasingly difficult for domestic insurers to compete without liberalization.

Capital Movement Directives

Two EC directives have been key to the market integration process: (1) A 1986 directive ensuring free capital movement for long-term commercial transactions, bond issues, and unquoted securities;[13] and 2) a 1988 directive eliminating all restrictions on short-term and long-term transfer of capital, or of underlying transactions, and eliminating other discriminatory measures, such as certain taxes on investments. The latter proposal

[12]Large risks are defined with reference to the nature of the risk, including aviation, marine, and transport, and also to the size of the policyholder, who should meet two of the following minimum thresholds: (1) It should have assets of 12.4 million ECUs ($13 million); (2) it should have sales of 24 million ECUs ($25.2 million); and (3) it should have more than 500 employees.

[13]See appendix I. Capital movements directive adopted by the EC Council on November 17, 1986.

will go into effect for most countries on July 1, 1990.[14] Thus, a resident of one EC member state will have unrestricted access to banking services, stock exchanges, real estate markets, and other financial services in all EC countries.

Potential Roadblocks to Integration

The European Community is making significant progress in completing the Single Market Program. However, the process is far from complete. Many uncertainties and potential problems remain. Less economically developed member states that may not currently be able to compete with more developed states could try to slow progress toward financial integration. An economic recession within the Community could increase protectionist sentiment. Problems remain in harmonizing member states' tax rates and in coordinating home and host country controls. The question of reciprocity could reemerge. Finally, concern is increasing that member states are failing to implement approved directives, by legislation, promptly.

Tax Harmonization

Without the harmonization of tax rates among member states, the integration of the financial markets will not be complete. Harmonization of indirect tax rates, such as the value added tax (VAT), is especially important because it affects the costs of goods and services. Differing indirect taxes such as taxes on interest and dividend payments could distort capital flows and encourage tax evasion. Member states have not reached agreement on how to harmonize indirect tax rates. Political sensitivities to cede fiscal sovereignty, as well as the difficulties anticipated in administering proposed schemes, have slowed progress. Difficulties in reaching an agreement have been compounded by the need to obtain unanimity on tax issues, as required under the Single European Act.

Home and Host Country Control

Coordinating home and host country regulatory controls is crucial to the overall regulatory framework for EC 1992. Host countries would have the greatest regulatory control over the insurance sectors and the least control over the banking sector. In theory, giving supervisory authority

[14]Council Directive of June 24, 1988, for the implementation of article 67 of the Treaty of Rome. To be implemented by all EC countries by July 1, 1990, with the exception of Spain, Ireland, Greece, and Portugal, which are granted an additional 2 years. The Federal Republic of Germany, the Netherlands, the United Kingdom, and Denmark already allow free movement of capital. Belgium, Luxembourg, France, Italy, Greece, Portugal, Ireland, and Spain still have one or more restrictions that must be abolished under the directive.

to the home country's regulator is very appealing in an integrated market. However, actual implementation could be difficult. U.S. financial firm representatives, consultants, and EC regulators were uncertain about how and where to draw the dividing line between home and host country control. The directives themselves are open to interpretation. For example, it is unclear whether the Second Banking Directive can require banks from other EC countries to comply with local conduct of business rules since these rules may be perceived as providing consumer protection and thus be for the "public good." Basic conditions that must be satisfied before home country control becomes workable are (1) the ability of EC member state regulators to supervise their own institutions, and (2) the adequacy of minimum essential requirements used in this supervision.

Delays in Implementation

As the number of directives adopted by the Council grows, so too do the backlogs in passing the necessary implementing legislation in the member states. The Commission reported in June 1989 that of the 68 measures that should have been implemented by that date, only 2 had been incorporated into the national legislation in every member state. This backlog also creates a substantial administrative burden for the Commission, which is responsible for monitoring and enforcing the implementation of directives.

Within the financial services sector, where the EC's success in passing directives has been swifter than in other areas, the implementation of directives at the member state level is also lagging. The directive allowing Communitywide sale of mutual funds was passed by the EC in 1985 and became effective on October 1, 1989. However, according to an EC official, just 2 weeks prior to its effective date, the directive had been enacted by only 2 countries within their own legislation.

Objectives, Scope, and Methodology

The Chairman of the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations asked us to assess the potential impact of the EC's deregulation of financial services on U.S. financial institutions. Of particular interest to the Subcommittee at that time was the EC's possible application of reciprocity provisions to bar U.S. firms from the Community.

To satisfy the Subcommittee's overall objective, we established three subordinate objectives. First, we sought to identify the nature and extent of U.S. financial firms' participation in the EC markets. Second,

we attempted to identify the opportunities and challenges a single market in Europe may present to U.S. financial firms. Third, we sought to determine how appropriately the U.S. government is working to assure full and fair access for U.S. financial firms to European markets.

To identify the extent to which U.S. financial firms participate in EC markets and, thus, what is at stake for the U.S. financial industry, we collected data in both the United States and in Europe on the number, size, and activities of U.S. firms in the EC. We also collected data on the overall size and importance of EC financial markets. We obtained information from U.S. and European regulators, U.S. embassies and missions, the European Community, U.S. trade associations, U.S. and EC consultants, financial periodicals and reports, and international bodies and experts. We also met with representatives of U.S. banks, securities firms, and insurance companies in five EC financial capitals and the United States to identify the variety of activities and markets in which they participate.[15]

To identify the potential opportunities and challenges a single market might present for U.S. financial firms, we sought the views of U.S. financial firms in the EC and the United States. We also interviewed EC and U.S. government officials, consultants, and other experts, and reviewed their publications to gain a consensus of opinion concerning opportunities, challenges, and resultant strategies. Additionally, because U.S. laws and regulations have a considerable impact on U.S. financial firms' overseas activities, we identified key U.S. regulations and analyzed their effect.

To determine how the U.S. government has responded to the needs of the U.S. financial industry, we identified which U.S. governmental bodies monitor developments in EC financial markets. We analyzed their roles and responsibilities and how they responded to and coordinated with the financial community at large. We asked representatives of the U.S. financial community, the EC, consultants, and the U.S. government how they viewed the U.S. government's response.

Our work was conducted between March 1989 and January 1990 in accordance with generally accepted government auditing standards. The

[15]In the EC, we interviewed U.S. financial firm representatives in London, England; Brussels, Belgium; Frankfurt, West Germany; Paris, France; and Madrid, Spain. In total we interviewed representatives of 37 U.S. banks, securities firms, and insurance companies in the EC. These firms represent a broad range of size, activities, and level of commitment in the EC. In the United States, we met with New York headquarters representatives of financial firms.

House Subcommittee Chairman requesting this review asked that GAO not request official comments on a draft of this report. The views of responsible officials were obtained during GAO's work and are incorporated in the report where appropriate.

U.S. Participation in EC Financial Markets

An integrated EC economy, the goal of the EC's Single Market Program, would be one of the world's largest economies, with the financial services sector forming a key component in that economy. An integrated EC market will consist of 325 million people and have a gross domestic product over $4 trillion. It is estimated that the removal of internal barriers to create this single market will stimulate an additional 4.5 percent growth in the overall economy.

U.S. financial firms have long been active in European financial markets and have established networks of institutions throughout the EC. U.S. banks hold 5 percent of the EC's banking assets, U.S. securities firms are leaders in a number of European investment markets, and U.S. insurance companies are increasing their presence in the EC in anticipation of new opportunities. Therefore, these firms have a keen interest in the emerging single market and how it will affect their operations.

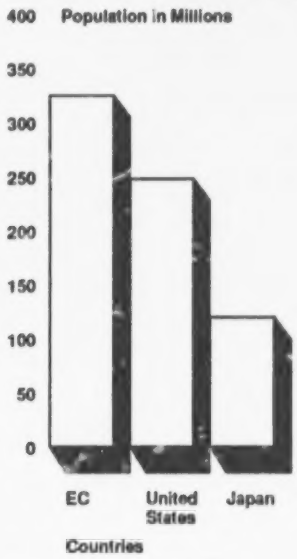
EC Marketplace Rivals That of the United States

The gross national product of the EC almost matches that of the United States and nearly doubles that of Japan (see fig. 2.1); the population of the EC nearly equals the combined populations of the United States and Japan (see fig. 2.2).

Figure 2.1: Gross National Products of the EC, United States, and Japan (1988)

Source: Salomon Brothers Inc.

Figure 2.2: Population of the EC, United States, and Japan (1988)



Source: Salomon Brothers Inc.

The United States has strong economic ties with the 12 members of the EC. Bilateral trade between the United States and the EC totaled approximately $150 billion in 1987, representing one-third of all global trade. The EC's member states purchase one-quarter of all U.S. exports and receive 40 percent of all U.S. foreign investment.

The Single Market Program not only will foster further integration of America's largest export market but also will increase the size of that market as well. An EC-sponsored study of the medium-term gains from the Single Market Program[1] estimated that market integration could add to the EC's gross domestic product from between 4.5 to 7 percent and create between 1.8 and 5 million additional jobs. Combined with a favorable set of government measures, the study estimated that the average added effects could lead to a medium-term rise in gross domestic product of 7 percent, with the creation of approximately 5 million additional jobs. The study estimated that the impact of liberalizing

[1]Four major aspects of the Single Market Program were analyzed; these included (1) removal of customs barriers, (2) opening of procurement markets, (3) liberalization of financial services, and (4) supply-side effects created by businesses' reaction to market integration and tougher competition. The estimated cost of all inefficiencies and barriers and thus the size of potential gains to be realized upon the removal of the barriers exceeds 200 billion ECU ($228 billion).

financial services alone is calculated to contribute an additional 1.5 percent to the EC's gross domestic product and nearly 500,000 additional jobs.

Importance of the Financial Services Sector in the EC's Economy

The financial services industries (banking, securities, and insurance) play a unique, pivotal role in energizing the overall EC economy as major employers and contributors. In addition, the EC's financial markets constitute a significant portion of the global financial market.

The significance of the financial services sector to the total EC economy is illustrated by measures of its contributions to employment, value added to production, and output.[2] In 1985, employment in the banking, finance, and insurance industries totaled over 3.1 million, representing 3 percent of the total work force in the EC. In the same year, the value added component constituted 6.5 percent of the combined EC gross domestic product and, based on an EC survey of 8 of the member states, totaled 200 billion ECUs ($228 billion).[3] The earnings rate of the financial services sector was twice the EC's average. Based on the EC's survey, bank loans and stock market capitalization in the EC countries are estimated to total 142 percent (or $6.1 trillion) and 116 percent (or $5.0 trillion) of the EC's gross domestic product, respectively.[4]

Banking

The EC's banking industry is among the world's largest. EC-based banks, for example, represented 2 of the top 10 banks in the world in 1987, 44 of the top 100, and 162 of the top 500.[5]

Banks in EC member states constitute a larger source of direct lending to nonbanks than do banks in any other individual country. They account for 34 percent of the world total, just ahead of the Japanese banks. U.S. banks, in contrast, account for only 7 percent of direct lending, less than either French or West German banks alone.

[2]The value added by the financial services sector equals the total value of financial firms' output (measured by wages and profits) less the value of inputs purchased from other firms.

[3]Dollar value based on currency rates prevailing on November 30, 1989: 1 ECU = $1.1392.

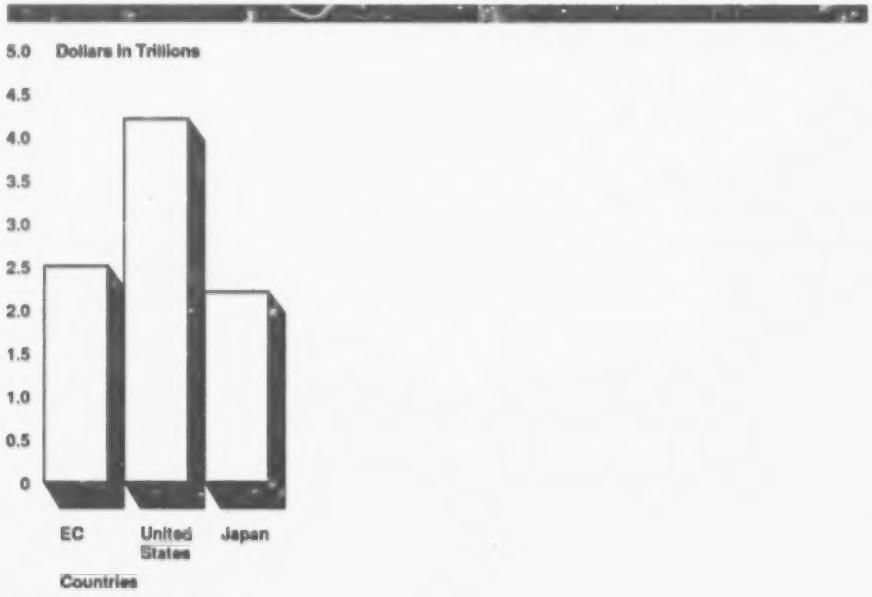
[4]Dollar figures are based on Community gross domestic product as of December 1988.

[5]Rankings are based on the size of assets in 1987.

Securities

The combined EC securities markets are comparable in size to those in the United States and Japan. Figures 2.3 and 2.4 compare the capitalization of EC, United States, and Japanese bond and equity markets. At the end of 1987, the EC bond market was three-fifths the size of the U.S. market, and larger than the Japanese market.[6]

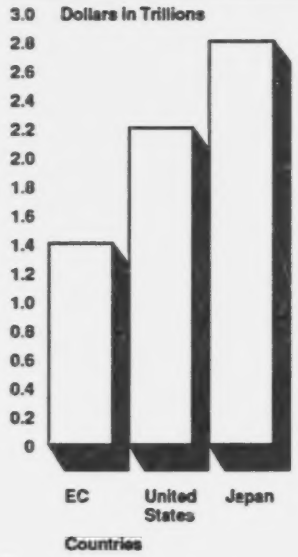
Figure 2.3: The Size of the Bond Market in the EC, United States, and Japan
(December 1987)



Source: Salomon Brothers Inc

[6]Because the sizes of the bond and equity markets are expressed in dollars, the relative relationships of the markets will vary with the value of the dollar versus other currencies.

Figure 2.4: The Size of the Equity Market in the EC, United States, and Japan
(December 1987)



Source: Salomon Brothers Inc.

The capitalization of EC equity markets was also approximately three-fifths the size of the U.S. market, but only one-half the size of the market in Japan.

Insurance

The EC accounts for approximately 22 percent of the $1 trillion private insurance market in the world, making the EC the second-largest global market after the United States. In comparison, the U.S. market generates approximately 43 percent of the world's premiums, while Japan generates approximately 20 percent. Approximately 60 percent of EC premiums are from non-life insurance policies; life insurance accounts for approximately 40 percent of the insurance market and is the faster-growing sector. Since 1965, the insurance market in Europe has grown at a faster rate than the U.S. market. Table 2.1 illustrates the relative share of the world's insurance markets between 1960 and 1985.

Table 2.1: Share of World Insurance Volume Represented by the EC, North America, and Japan (1960-85)

Figures in percent

	Share			
	1960	**1970**	**1980**	**1985**
EC	18.4	21.2	27.3	22.2
North America	72.0	63.5	46.9	50.4a
Japan	2.2	7.0	13.7	17.3
Other	7.4	8.3	12.1	10.1
Total	**100.0**	**100.0**	**100.0**	**100.0**

[a]Data for 1985 represent the United States and Canada only.

Source: Commission of the European Communities.

While the share of the global insurance market represented by the EC member states increased 48 percent between 1960 and 1980, the EC's global market share declined between 1980 and 1985. A significant portion of this decline is due to the appreciating value of the dollar over the same period.

According to an insurance industry study, the prospect that growth in the European insurance markets will continue to outpace the U.S. insurance market is good. The development of public social insurance systems in Europe has slowed; this slowdown is expected to increase demand for private insurance. On the whole, public insurance systems have been more important in Europe than in the United States. This fact explains, in part, why the percentage of private insurance premiums in the gross domestic product of Europe is only 4.9 percent, whereas in the United States it is 7.5 percent.

U.S. Financial Institutions in the European Community

U.S. financial institutions have a large and active presence in the EC financial markets. Among U.S. financial institutions, U.S. banks have been active in Europe the longest and have the largest stake in the EC. Many U.S. securities firms have entered the EC in the last 20 years and are now among the leaders in product innovation, investment expertise, and sales. The presence of the U.S. insurance industry in EC states is small, but growing. In all three financial sectors, most U.S. firms in the EC are active in the wholesale markets serving large institutions.

U.S. Banks in the EC

Officials told us that the overseas presence of U.S. banks grew over the last 25 years in part because U.S. banks abroad did not need to comply with U.S. reserve requirements, and their deposits are not subject to

Federal Deposit Insurance Corporation assessments. U.S. banks, therefore, expanded their overseas networks to conduct international banking in Euromarkets, where they were free from U.S. monetary regulations and capital controls.

U.S. banks have a presence in every EC member state. At the end of 1988, 33 U.S. banks were operating a total of 149 branches throughout the EC; 17 U.S. banks owned subsidiaries in the EC. The combined assets of these branches and subsidiaries totaled over $210 billion and represented approximately 5 percent of the banking assets of the EC.

The highest concentration of U.S. branches and subsidiaries, as well as approximately 65 percent of their assets, is in the United Kingdom. In 1986, U.S. banks in the United Kingdom, the largest banking market in the EC, accounted for 11 percent of bank assets there. U.S. banks are also well represented in the next-largest market in the EC, West Germany. In 1987, U.S. banks in West Germany operated more branches and subsidiaries (20) and conducted a higher percentage of business volume (21 billion ECUs, or $24 billion) than did banks from any other foreign country.

Though the U.S. banks still maintain a large presence in the EC, their position has declined during the 1980s. Several U.S. banks have sold retail networks to EC banks, and others have exited or are phasing out of particular markets, such as securities trading and underwriting, commercial paper, and government bonds.

U.S. Banks Most Active in Wholesale Markets

Within the wholesale banking market, U.S. banks are deemphasizing their traditional commercial lending activity and stressing investment banking activities instead. The large multinational corporations that formerly sought loans from international banks now meet their capital needs directly in the securities markets. U.S. banks have adapted to the changing financial environment by targeting niche markets. For example, in 1988 U.S. banks constituted 9 of the top 20 lead managers of syndicated loans internationally. In the same year, U.S. banks also represented 7 of the top 20 dealers of Eurocommercial paper and Eurocertificates of deposit. U.S. banks are also among the leaders in the Eurobond markets. Niche markets include mergers and acquisitions, investment management, and leveraged buy-outs. U.S. banks also continue to participate in traditional international banking activities, such as foreign exchange and securities trading, leasing, and trade financing.

Only one U.S. bank is actively pursuing the European retail market. Most U.S. banks exited from this banking business because of low profits. During the 1980s, U.S. banks sold retail networks in Belgium, France, Italy, Spain, and the United Kingdom.

Several U.S. banks are entering new markets in Europe as regulatory controls in the EC are liberalized. Some U.S. banks are also beginning to market life insurance, while others are marketing mutual funds.

U.S. Securities Firms in the EC

Nearly all major U.S. securities firms are present in the financial markets of the EC. For example, 9 of the top 10 U.S. securities firms, ranked by total broker-dealer capital, have a presence in the EC, as do 17 of the top 25 U.S. firms. In London, the EC's leading securities market, U.S. firms operated a total of 55 offices in 1988. However, we were unable to determine the exact number, locations, or size of these firms in the rest of Europe. This lack of data may be a result of the federal government's limited oversight responsibility for the foreign activities of U.S. securities firms.

As is illustrated in table 2.2, U.S. securities firms are successful in a number of activities in the EC's wholesale markets. They are among the top managers of international equities and advisers on mergers and acquisitions.

Table 2.2:Frequency of U.S. Securities Firms Among Top-Ranked Participants in Selected International Financial Markets (1988)

Market	Measure	Number of U.S. securities firms
Lead managers[a] International equities	Top 10[b]	5
Lead and co-lead managers International equities	Top 20[b]	7
Mergers and acquisitions advisers worldwide	Top 25[c]	12
Mergers and acquisitions advisers Europe buying into the U.S.	Top 20[b]	11
Mergers and acquisitions advisers U.S. buying into Europe	Top 5[b]	5

[a]Lead managers organize the syndicate and typically take on a majority of the risk in return for a higher fee.

[b]Institutions ranked by value of transactions.

[c]Institutions ranked by number of transactions.

Source: Euromoney, February, March 1989.

U.S. securities firms face competition from the investment subsidiaries of U.S. commercial banks, European universal banks, specialized firms in the EC, and financial firms outside the EC. Industry consultants told us that one of the advantages U.S. firms have in operating in the EC is their "European" composition. U.S. firms in the EC are said to be more inclined to develop a cosmopolitan team representing several member states than might a securities firm indigenous to an EC member state. Therefore, the proposals developed by U.S. firms could be perceived by EC clients to contain less potential bias.

U.S. Securities Firms Are Active in Both Wholesale and Retail Markets

U.S. securities firms in the EC serve two types of clients: institutions and individuals. Institutions include member state governments, EC and multinational corporations, and insurance and pension funds. U.S. firms provide a variety of investment banking and brokerage services, including fee-based advice (mergers and acquisitions, investments), securities underwriting, sales and trading, corporate finance, and equity placements. Brokerage activity has historically served clients with U.S. investment products. With the liberalization of exchange controls, the firms are expanding their portfolios to include European and Japanese products.

Representatives of the financial community in Europe told us that U.S. institutions have a reputation within the EC for product innovation. Financial products and practices first developed in the United States have been introduced to the European market by U.S. institutions (e.g., futures, options, and swaps).

U.S. Insurance Companies in the EC

U.S. insurance companies have only a limited presence in the EC market because of market forces and a general lack of interest on the part of U.S. companies. For example, in West Germany, the largest national insurance market in the EC, the market share of U.S.-owned companies in 1984 totaled only one-half of 1 percent, based on gross premium revenue. In most EC countries, the insurance industry is one of the most strictly regulated segments of the economy, and it has been the most difficult financial industry to liberalize under the Single Market Program. Because the insurance sector is one of the most closed sectors in EC member state economies, foreign companies usually play only a minor role in the national markets. For example, in the major national markets in Europe, the average market share of foreign firms is approximately 9 percent. A leading industry analyst observed that, even in relatively

open markets within the EC, the presence of foreign insurers is small due to language and cultural barriers.

The low penetration of U.S. companies in the EC is indicative of the lack of foreign penetration by American insurance companies worldwide. Though 6 U.S. insurance companies are among the 15 largest in the world,[7] only 1 percent of total premium revenue for the U.S. insurance industry is derived from foreign sources. In 1985, worldwide investment by U.S. insurance companies totaled only $7.9 billion, or 3.4 percent of total foreign investment by U.S. business. Of the foreign investment of U.S. insurance companies, however, 70 percent occurred in Europe.

A lack of interest by U.S. firms in the EC market partly explains the small presence of U.S. companies. A recent survey reported that 80 percent of U.S. insurance executives have little or no notion of the market potential of the EC. Other reasons given for the low U.S. penetration in Europe included (1) the conservative nature of the industry and the lack of inclination to explore new territories; (2) the existing saturation of the insurance market, especially in northern Europe; and (3) the presence of competing opportunities in the Far East.

The primary business for the few large U.S. insurers in the EC is property and casualty coverage for large industrial clients. In our interviews with representatives of U.S. insurance companies in Europe, however, we were told that the U.S.' presence may grow. Several U.S. companies have plans either to establish operations in the EC or to buy existing companies in the EC. These new entrants are targeting both the life and non-life markets. We were told that the most attractive markets in the EC are in the southern member states—Spain, Italy, Greece—where, historically, domestic regulation has been more restrictive and foreign insurance penetration has been low.

[7]Based on overall business in dollars in 1987.

Access to the European Community Appears Open, but Other Factors May Limit U.S. Financial Firms' Participation

U.S. financial firms are apparently assured access to the EC's financial markets in spite of initial concerns that the Community might bar them from operating there. Whether or not these concerns were well founded, both U.S. financial firms and the U.S. government actively lobbied EC and member state governments for equal access to Community markets. Firms also took organizational steps to insulate themselves better from the possibility of exclusion; some are still considering taking such steps.

We found little reason to believe that U.S. financial firms will face overt discrimination in EC markets after the implementation of the Single Market Program. However, the EC's program for developing a single market is far from complete, and some unsettled issues remain that still could alter this current mood of optimism.

U.S. firms do not plan to expand their presence within the EC. Numerous other obstacles and strategic variables could influence their global strategies and limit their ability or desire to participate in Europe. U.S. financial firms are particularly concerned about U.S. regulatory restrictions on their overseas activities and the cost and availability of capital.

U.S. Firms Foresee Increased Opportunities in the EC

The 1992 program offers more opportunities than it does barriers, in the view of a majority of representatives of U.S. financial firms we interviewed. U.S. financial industry executives, their consultants, and market experts foresee a more open and liberal financial market in the EC now that the issue of reciprocity has apparently been resolved. They anticipate new and expanded opportunities in specific market sectors, such as retail and private banking or insurance and investment products, and across sectors, such as in the benefits to be derived from the freer flow of funds and the consolidation of operations. U.S. financial firms believe that they are well positioned to benefit from these opportunities because of their international networks and experience operating across borders, their expertise and their product innovation, and the breadth of services they offer.

Retail Banking

Historically in the EC, retail markets have been heavily protected through domestic regulation; some countries (e.g., Spain and Italy) restrict foreign acquisitions or participation in domestic banks and the marketing of banking services by foreign institutions across their borders. These and other restrictions in retail banking result in wide price differentials among countries for equivalent banking products. By making it easier to establish banking offices and by allowing the sale of

banking products across national borders, the Second Banking Directive may create profitable opportunities for foreign banks to exploit these price differentials. The increased competition arising from new foreign bank activity may also reduce costs for the consumers of financial services as well as stimulate the introduction of new products and services. All this activity can be expected to further increase consumer demand for financial services in the Community.

However, as noted in the prior chapter, most U.S. banks are no longer active in retail markets, having sold many of their retail franchises in recent years. U.S. banks, with few exceptions, now operate almost exclusively in wholesale banking markets, which we were told already are largely deregulated and are not expected to offer new opportunities akin to those expected in retail banking.

Private Banking Services

Offering private banking services for high-net-worth individuals is an attractive venture for banks and investment houses. The full liberalization of capital movement under the Single Market Program will offer a wider range of cross-border investment possibilities, including U.S. investment products, to EC investors. This liberalization will, therefore, boost the demand for private banking services.

U.S. banks and U.S. securities firms that offer brokerage services already are actively providing private banking services. U.S. securities firms market U.S. investment products, where the actual accounts are held in the United States and only transactions and servicing are performed in the Community. For U.S. banks, offering private banking services is attractive because these services generate high fee income without a large capital commitment. This fact is especially important in light of the new worldwide capital adequacy requirements for banks.

Mergers and Acquisitions

Corporate finance, specifically the financing and facilitation of corporate mergers and acquisitions, is expected to be a highly profitable activity in the EC. Many EC businesses anticipate the need for greater expansion and market penetration as a result of more open and competitive markets after 1992. Concurrently, other EC businesses that doubt their competitiveness after 1992 see this as an excellent time to sell their firms. The following data provide an idea of the magnitude of corporate mergers already taking place on a cross-border basis (see table 3.1).

Table 3.1: Cross-Border Mergers (January Through June 1989)

EC nation of acquired company	Value of deals (ECUs in millions)[a]	Number of deals
United Kingdom	5,956	101
France	2,299	91
Italy	2,039	52
West Germany	1,774	90
Spain	1,084	65
The Netherlands	511	47
Portugal	310	12
Belgium	180	27

[a]One European Currency Unit (ECU) is roughly equivalent in value to $1.14.
Source: The 1992 M&A monthly's European Deal Review.

Many U.S. institutions and consultants predict continued growth in this area. U.S. financial institutions that have built merger and acquisition experience in the United States expect to benefit from these increased cross-border mergers. U.S. businesses' European acquisitions, totaling 3.6 billion ECUs ($4.1 billion) during the first half of 1989, create a natural customer base for these U.S. financial firms.[1]

The EC is near agreement on a merger policy that will reduce the barriers national governments are able to impose on large cross-border mergers. The takeover policy would give the EC the power to rule on large mergers and leave decisions on smaller takeovers with the member states involved.[2] Passing clear ground rules for takeovers in the EC will facilitate the expansion of firms through mergers and acquisitions and perhaps further increase the demand for merger and acquisition services.

Insurance Products

Opportunities for U.S. insurance companies in the EC's insurance sector are reflected in several important measures of potential EC insurance demand. First, as of 1985, premiums per head in Europe were roughly one-third of those in the United States. Second, for the period 1970-85, the average real growth rate in premiums was higher in Europe than in the United States, 4.3 percent versus 3.2 percent, respectively, despite

[1]Among all acquiring nations, the value of U.S. acquisitions in Europe trailed only those made by French firms during this period.

[2]Under the current proposal, the European Commission would review a merger if it exceeds all three of the following thresholds: (1) worldwide combined turnover exceeds 5 billion ECUs ($5.7 billion), (2) inter-EC combined turnover exceeds 250 million ECUs ($285 million), and (3) not more than 66 percent of the turnover of either partner is in any one member state.

equal growth rates in gross national product. This greater demand for insurance in Europe is reflected in a larger income elasticity of insurance demand in Europe as compared with the United States.[3] Though other factors, such as differences in our social insurance and legal systems, may account for the greater demand figures in Europe, they would seem to indicate that the U.S.' market is relatively more saturated than Europe. This conclusion is supported by U.S. insurers we interviewed in the EC. They anticipated increased growth, especially in lower-tier EC countries, as the Single Market Program's impact is felt.

To date, the greatest progress in liberalizing insurance markets under the Single Market Program has occurred in the non-life sector for large risk (industrial and commercial) customers. U.S. insurers are concentrated in this sector and should benefit when the freedom granted by the Second Non-Life Insurance Directive to market policies across Community borders is implemented in most member states by July 1990.

Market participants and experts believe, however, that the greatest opportunities in the EC insurance industry will not occur until the life insurance sector is liberalized and companies are free to promote life insurance products across borders. The life insurance industry has been heavily regulated to ensure consumer protection. This regulation has produced wide price differentials among EC countries for similar products. For example, in Portugal, basic life insurance is priced 10 times higher than a comparable policy in the United Kingdom. Market opportunities will be available to those firms able to offer competitively priced insurance products following liberalization.

Investment Funds

Growth is also likely in demand for new investment vehicles, such as UCITS (or mutual funds), pension funds, and Employee Stock Ownership Plans as a result of the EC's Single Market Program. Currently, the market for these investment products in Europe is half the size of the U.S. market. In fact, U.S. mutual fund industry assets of $810 billion in 1988 are almost equivalent to mutual fund assets in the rest of the world combined. Given a comparatively higher savings rate in the EC than in the United States, investors in the EC are likely to seek out new investment products as they become increasingly available. The EC's UCITS Directive

[3]Income elasticity of insurance demand measures the relationship of the percentage change of insurance demand to the percentage change of the gross national product. For the period 1970-85, U.S. income elasticity of insurance demand was roughly 1.3. In Europe, only Italy has a lower elasticity.

permits cross-border selling of funds, subject only to host country supervision of their marketing, once the funds are authorized in one member state. Such authorization should increase sales of these investment products. U.S. institutions, with their prior experience in marketing and packaging these products in the United States, should benefit from these liberalizations.

Free Capital Flows and Financial Market Developments

The scheduled elimination of exchange controls in the EC is essential to achieve integration of EC financial markets because of its cross-sectoral impact on all financial services. The freedom to offer services across borders is, for the most part, irrelevant, unless investors, borrowers, and intermediaries can transfer capital freely across borders. Exchange controls are a primary, but not the only, constraint on capital movement. Experts say that other barriers to free capital movement, such as restricted access to foreign brokership licenses, discriminatory taxes on purchases of foreign securities, and limitations on balance sheet holdings of foreign securities, indirectly limit capital movement. The EC's 1992 program will also remove these restrictions.

The free movement of capital should offer new and increased opportunities for providers of non-EC financial products, including those from the United States. For example, some U.S. securities firms in Spain intend to market U.S. products to Spanish citizens once exchange controls are lifted there. Currently, Spanish citizens may only invest outside Spain through a Spanish bank, subject to withholding taxes on their investment.

A single capital market should also stimulate further development of derivative products, such as futures and options and securitized assets. U.S. financial institutions have a reputation for expertise in such sophisticated products and should profit as a result. For example, one U.S. investment firm, with considerable experience in the U.S. mortgage-backed securities market, recently entered into an agreement with a major French bank to assist it in developing a mortgage-backed securities operation.

Cost Savings From Consolidation

The integration of the EC should enable financial firms to reduce their administrative costs by consolidating some of their activities. Harmonizing accounting and financial reporting standards for banking, securities, and insurance firms will allow greater consolidation of accounting and information systems. The integration of markets and the ability to offer

services from a centralized location after 1992, coincident with improvements in information technology, enable further consolidation of administrative functions. Some U.S. institutions have already begun to consolidate these functions, while others plan to do so in the near future. In some instances, the consolidation will lead to cutbacks in personnel, which could be incorrectly interpreted as a retreat from the market, even though volume and profit levels are increasing.

U.S. Institutional Strategy: Generally Not One of Expansion

Most U.S. financial firms that we contacted do not plan on expanding their presence in the EC as a result of the Single Market Program. Several banks already in the Community are scaling back their commitment and retreating from some activities and countries altogether. Other U.S. banks that might seem likely candidates for new entry into the Community expressed little interest at this time. Securities firms, while perhaps more optimistic about the Single Market Program, have not translated their interest into specific plans for expansion. Only in the insurance industry did we find evidence of increased entry by U.S. firms.

U.S. Commercial Banks Are Targeting Their Opportunities

In contrast to their EC competitors, U.S. banks are not expanding in the EC despite the new opportunities anticipated under the 1992 program. Instead, U.S. banks are using their limited capital resources to target the most profitable niche markets and opportunities, while also restructuring their operations to reduce costs. In some cases, this restructuring has led to reductions in staffing or withdrawal from some relatively unprofitable activities. Also noteworthy has been the sale of some U.S. banks' retail operations in Europe.

Representatives of some large regional banks told us that they had no interest in expanding into the EC at present. These banks see better opportunities available in the United States, such as those arising from the removal of U.S. interstate branching restrictions, than might exist in the EC.

U.S. Securities Firms Seek Little Expansion

While securities firms are optimistic about their prospects in the EC after 1992, most do not plan on expanding there. Generally, U.S. securities firms are responding more to member state changes in regulation than to the EC's Single Market Program changes. In Spain and France, stock exchanges and domestic securities markets will become more accessible to foreign entry, in part as a response to 1992 liberalizations. To meet local requirements in these countries, U.S. securities firms are forming

separately capitalized and locally incorporated brokerages in order to underwrite and trade domestic securities. West German experts told us that several U.S. securities firms established German banking subsidiaries following the recent relaxation of German law, which now permits foreign-owned German banks to underwrite domestic Deutsche mark issues. U.S. securities firms are also looking toward the formation of a German futures and options exchange in the early part of 1990.

In the United Kingdom, where the securities markets are larger and more global in character than elsewhere in the EC, U.S. securities firms are generally larger and more knowledgeable about the Single Market Program's potential impact. Even so, their actions have been more defensive than expansive. Some U.S. securities firms, which had previously operated in London as branches, have established separately incorporated U.K. subsidiaries. Their reasons for doing so are to respond to the concerns of U.K. regulatory authorities that their activities be under some form of supervision and to ensure against reciprocity provisions, should they reemerge in the Community, by establishing an EC base.

U.S. Insurance Firms' Limited Presence May Grow

With the growing prospect of a single market in the Community, there are indications of increased U.S. insurance industry interest in its markets. Both life and non-life U.S. insurers are establishing themselves in the EC; those already established in the EC are reorganizing to prepare for the single market.

Our discussions with representatives of the U.S. insurance industry in the Community indicated that at least eight U.S. companies were either expanding their networks within the EC, establishing distribution alliances with EC banks and insurance companies, or opening new offices. Several other U.S. insurers were studying possible entry into the Community. Some companies planned to enter the large-risk non-life insurance market, which has been the most attractive to U.S. firms in the EC to date. Most of this activity is expected to occur in the southern-tier EC countries, where penetration by insurance companies has traditionally been low.

Two large U.S. international insurers already in the Community have recently reorganized. They are attempting to portray themselves better as "European" and to guard against reciprocity by employing a "hub-and-spoke" strategy. They have established a primary headquarters subsidiary (the "hub") in the EC, with the remaining network of

branches and subsidiaries (the "spokes") in Europe reporting to the European headquarters. Through this organizational structure, U.S. insurance companies are able to qualify for the single passport, portray a unified European corporate image, and centralize data and administrative functions while still maintaining a local presence.

U.S. insurance companies have a greater incentive than banking and security firms to establish a subsidiary base in the Community. This is because branches of non-EC insurance companies must meet both EC-wide and home country solvency and other requirements, whereas branches of EC insurance companies need only adhere to their home country requirements.

Factors and Impediments Affecting U.S. Firms' Strategy

U.S. financial firms are not expanding in Europe to the same degree as their EC competitors, although they have equal access to the single market and its new opportunities. However, their reluctance may be strategically sound, considering possible impediments and other considerations U.S. financial firms must also factor into their plans. The following section discusses factors institutions cite as affecting their intentions. We did not attempt to weigh the relative importance of various factors, given that no two institutions are entirely alike. However, U.S. regulatory restrictions on the overseas securities activities of U.S. banks ranked as a primary consideration for a large majority of U.S. banks.

U.S. Bank Law Restricts the Nature and Extent of U.S. Banks' Securities Activities

A majority of U.S. bank officials with whom we spoke in the EC believed that U.S. bank laws and regulations placed them at a competitive disadvantage in relation to EC banks. Regulation K was singled out as having the most detrimental effect. Regulation K[4] restricts the absolute and relative size of certain activities of nonbank subsidiaries overseas, most notably their securities dealing, distribution, and underwriting.

The Glass-Steagall Act[5] separates commercial and investment banking in the United States and does not permit nonbank activities to be conducted within the bank itself. The Glass-Steagall Act applies only to U.S.

[4]Regulation K was issued by the Board of Governors of the Federal Reserve System under the authority of the Federal Reserve Act, the Bank Holding Company Act of 1956, the International Banking Act of 1978, the Bank Export Services Act, and three International Lending Supervision Acts.

[5]The Glass-Steagall Act is contained in sections 16, 20, 21, and 32 of the Banking Act of 1933 (12 U.S.C. Sec. 24, 377, 378, and 78).

domestic banking activities. International operations permissible for U.S. banking institutions overseas are set forth in Regulation K and allow U.S. banking organizations to be more competitive in foreign markets by permitting them to do a broader range of securities activities overseas than is permitted in the U.S. market. However, Regulation K limits the absolute and relative size of such activities, unlike the EC's regulatory framework, which is increasingly shifting toward universal banking. The Glass-Steagall Act indirectly affects U.S. overseas banking operations since the volume restrictions provided for in Regulation K depend, in part, on the restrictions on domestic equity underwriting imposed by Glass-Steagall. U.S. banks have also insisted that their inability to offer the same range of services in both domestic and international markets has hindered their efforts to compete with foreign banks.[6]

Regulation K

Regulation K limits have become more burdensome in recent years because of trends in corporate and investment finance. Demand for banks' intermediary role in providing long-term loans has waned during the 1980s as corporate borrowers have increasingly gone directly to investors for funds in order to reduce their borrowing costs.[7] This increased demand from the banks' customers for alternative financing vehicles has been matched by the banks' efforts to reduce their lending activity and boost fee income. In part, this action reflects U.S. banks' attempt to increase their profitability and, in part, it is a reaction to newly imposed capital adequacy standards that require increased capital to back increases in bank assets.

The complexity and size of financial placements have also grown in recent years. Today, financing packages are increasingly requiring a mix of debt and equity. These placements often require the underwriter to assume a portion of the equity. U.S. bank representatives stated that they are unable to compete with large EC universal banks for new corporate customers, or even retain their present customer base, without the ability to lead or participate substantially in equity underwriting and distribution. Currently, Regulation K limits equity underwriting by U.S. banks to $2 million per issue per subsidiary. Another provision of the regulation limits the amount of investment by U.S. banks in a subsidiary

[6]For a discussion of Glass-Steagall, see the GAO report, Bank Powers: Issues Related to the Repeal of Glass-Steagall Act (GAO/GGD-88-37, January 22, 1988).

[7]Net international bond offerings grew from $28 billion in 1980 to $125 billion in 1985, while net international bank lending decreased from $160 billion to $105 billion during the same period.

joint venture or portfolio investment to a total of $15 million, or 5 percent of the investor's capital and surplus. Some banking institutions have interpreted Regulation K as permitting up to $15 million per issue, or 5 percent of the institution's capital and surplus.

According to bank officials, two methods are used to partially circumvent the equity underwriting limits of Regulation K. The first is a consortium approach, whereby the bank owns up to the maximum 5 percent in a consortium of the associated underwriting risk. In the other method of circumvention, a bank merely spreads a placement, up to $2 million per subsidiary, around its international subsidiaries to a maximum of $15 million per issue. U.S. banks must, therefore, forsake any amount in excess of $15 million to competitor institutions or attempt to pass through these positions by the end of each day.[8]

In addition, the size of individual placements has grown. A representative of one leading U.S. bank told us that the $15 million limit has not been adjusted for corresponding increases in the size of underwritings.

Regulation K Forces More Costly Organizational Structure

Regulation K prohibits U.S. member banks from conducting any nonbank activities in overseas branches. Such activities are restricted to subsidiaries, although these subsidiaries can conduct a full range of banking activities as well. The requirement that these activities take place within a subsidiary, together with the volume restrictions noted above, has led to costly and complex organization structures for these institutions, according to bank representatives. This result, they feel, is in conflict with the philosophy of the EC's Second Banking Directive, which endorses a universal banking model, under which banks are free to conduct a wide range of activities within the parent bank or its branches. Most EC countries follow this approach, while other member states are expected to assume the directive's broader powers through the process of regulatory convergence discussed in chapter 1.

Our discussions with officials in Spain and France revealed that financial regulatory reform in these countries creates disadvantages for U.S. banks as compared with their EC competitors. The latter are free to conduct the same activities without the additional organizational, licensing, or capital requirements of establishing subsidiaries able to conduct nonbanking activities.

[8]Regulation K limits apply only to close-of-day positions; therefore, banks are required to sell any intraday holdings in excess of $15 million by the end of the day.

Spain's securities markets have recently been deregulated, in anticipation of 1992. As part of this deregulation, banking and securities markets have been opened to foreign financial firms, including those from the United States.

Securities underwriting in Spain requires an agency license. This license is automatically granted to banks, including the branches of EC universal banks that conduct securities activities.[9] However, U.S. banks are only permitted to conduct underwriting activities within a subsidiary under U.S. law and, according to bank officials, these subsidiaries are not viewed as banks by Spanish regulatory authorities. Therefore, U.S. banks' securities subsidiaries do not receive this automatic license approval. The U.S. banks' securities subsidiaries must, therefore, apply for separate licenses that require an investment of 700 million pesetas ($6 million) in capital.[10] This cost is not incurred by their EC competitors.

One U.S. bank manager complained that these additional requirements and costs take away the flexibility to ease into underwriting activities while building a client base. Instead, a high minimum capital investment must be committed from the start with the hope that adequate return on investment can later be generated to justify it.

U.S. banks in France are faced with a similar predicament. While EC banks are free to conduct investment banking activities within the bank itself in France, U.S. banks can only conduct these activities in subsidiaries. Accordingly, U.S. banks have established French subsidiaries, referred to as Article 99 investment companies (or societe financiere), with a 7.5 million French francs ($1.2 million) capital requirement for each company.[11]

Restrictions on U.S. Interstate Banking

Bank officials have noted that U.S. interstate branching restrictions under the McFadden Act and the Douglas Amendment to the Bank Holding Company Act have resulted in a U.S. banking industry that is more

[9]Officials stated that in addition to the agency license needed to conduct securities activities in Spain, separate licensing and capital requirements must be met to obtain a broker or broker-dealer license to operate on the Madrid Stock Exchange. Foreign participation in these brokerships is currently limited to 30 percent, increasing to full ownership in 1992. Only two of the U.S. institutions we interviewed have purchased a broker participation licensed in the exchange.

[10]Using an exchange rate of 120 pesetas to $1, in effect on November 30, 1989.

[11]Using an exchange rate of 6 French francs to $1, in effect on November 30, 1989.

fragmented than Europe's. Slowly, states are relaxing branching restrictions on a regional basis, but some U.S. international money center banks are still excluded from these regional compacts.

The banking sector in Europe is more concentrated than in the United States, in part because of geographic restrictions limiting expansion in the United States. For example, of the world's top 500 banks in 1987 as measured by total assets, 162 are from the EC, while only 28 are from the United States. The EC's 1992 program will likely increase banking concentration in the Community, as EC banks expand their presence from a national to a European scale. Thus, U.S. banks will encounter even larger and more powerful EC competitors while facing handicaps from restrictions on their ability to grow domestically. These developments have led not only bankers but other observers, including the Federal Deposit Insurance Corporation, to argue that present restraints are no longer appropriate in today's financial marketplace.

Securities and Exchange Commission Disclosure Requirements

U.S. disclosure requirements make U.S. markets less desirable to foreign issuers and U.S. investment products less attractive to foreign investors, according to U.S. institutions active in EC securities markets. Bankers told us that the Securities and Exchange Commission requires that their financial statements adhere to U.S. generally accepted accounting principles. Thus, some foreign issuers must maintain a separate set of accounting records and release more information than they would if they raised funds in EC markets. For example, some issuers may hesitate to disclose management compensation, as required by the Securities and Exchange Commission, owing to the prevalence of kidnapping in some countries. As EC securities exchanges grow and improve, corporate issuers may increasingly turn to them as an alternative to U.S. capital markets to avoid U.S. disclosure and other requirements.

We were told that some EC investors, particularly high-net-worth individuals, are reluctant to invest in U.S. products and, therefore, to deal with the U.S. firms that market them, because of Securities and Exchange Commission disclosure requirements. According to some U.S. investment services firms, mandatory disclosure of acquisitions either in excess of 5 percent of capital or following a takeover deters those investors who prefer anonymity.

Some EC and Member State Impediments May Remain

The liberalizing nature of the 1992 program does not mean that all the barriers presently encountered by U.S. financial firms in the EC will immediately disappear or that others will not be erected. For example, U.S. banks will encounter the dilemma of whether to continue to conduct most of their activities in a branch structure in the EC for cost considerations or to opt for an EC-incorporated subsidiary network in order to enjoy the single passport and other freedoms. The Single Market Program also should not eliminate the dominance of some EC financial firms. Finally, because the EC's liberalization will be an uneven and imperfect process, some opportunities may not be forthcoming until sometime after 1992.

The Organizational Dilemma for U.S. Banks Operating as Branches

U.S. banks have created separate subsidiaries in the EC to conduct nonbank activities, but a majority of their overseas banking activities are conducted in branches, rather than subsidiaries, primarily for cost reasons. However, under the Single Market Program, branches from third countries are not entitled to single passport powers. In addition, they may face further member state capital and other requirements.

Thus, U.S. banks that operate in the EC as branches of their U.S. parent bank will not benefit from the new powers available under the EC's Second Banking Directive, including the single passport power to offer services freely across borders and to establish branches anywhere in the EC without obtaining prior authorization. These freedoms and expanded powers will only be available to banks incorporated in the EC, while non-EC branches will remain under the authority of individual member states.

Second, even after the 1992 program is complete, some countries, notably Germany, may continue to set capital requirements for branches of non-EC banks.[12] Member states remain free to apply these requirements under the EC's First Banking Directive. In applying these separate capital standards, non-EC branches are treated like stand-alone subsidiaries for capital adequacy purposes.

[12]Non-EC banks with branches in West Germany are concerned that they will have to meet capital requirements not prescribed for branches of EC banks. The United States has raised this issue with the EC, but was told that this was a bilateral German-U.S. problem and did not concern the EC. The U.S. Treasury Attache in Bonn believes that basing different requirements on country of origin is discriminatory, and that it is a violation of U.S.-German treaty obligations. According to the Treasury Attache, this dispute has not been resolved.

Third, it is uncertain how non-EC branches will be treated in matters other than those concerning capital requirements. The First Banking Directive states that non-EC branches may not receive more favorable treatment than EC branches. This provision would seem to indicate that where host country regulations are more lenient than the EC's, there will have to be a "leveling up" of host country requirements. Furthermore, each member state will be free to apply its own reciprocity provisions against non-EC branches.

Local Consortiums Remain Powerful

Close relations, legal and otherwise, between financial services suppliers and their customers and a high level of industry concentration dominate particular market sectors in some EC states. The result is that individual institutions are able to wield considerable economic power. This power is strengthened by ties among government, industry, and the financial community in some EC countries in the form of interlocking directorates, as well as in equity holdings.

It is difficult to separate the impediments for foreign firms posed by special supplier/customer relationships from the natural advantages enjoyed by any domestic institution in its home market. While U.S. financial firms generally stated that they are not experiencing overt regulatory discrimination, the influence and power EC financial firms wield in their home markets are often far greater than U.S. firms enjoy in the United States. Consortiums, or evidence of high industry concentration, are present in Spain, France, and West Germany—three of the four countries we visited.

In Spain, close ties are presumed to exist between domestic banks and industry, based on Spanish banks' large equity holdings in nonfinancial firms. Non-life catastrophic insurance is controlled by an industry cartel, which U.S. insurers are hoping will disappear after 1992. In addition, a government-owned insurance company until recently had a monopoly on the coverage for state-owned industries. Though state-owned industries may now obtain coverage from private sources, the traditional arrangements are expected to change slowly.

In West Germany, the "Big Three" private German banks (Deutsche, Dresdner, and Commerzbank) wield considerable power. The universal banking structure has allowed German banks to take large equity positions in some of Europe's biggest corporations. For example, officials stated that Deutsche Bank owns 28 percent of Daimler Benz, one of

Europe's largest corporations.[13] German banks' power extends well beyond their voting rights because of the proxy votes they control under their customers' accounts.

One leading U.S. institution in West Germany complained that German banks' power has been institutionalized in the syndication of German debt.[14] No foreign bank is allocated more than 1 percent of each syndication and, in total, foreign banks are limited to 20 percent, whereas Deutsche Bank alone is given a 16 percent share.

France is the most heavily concentrated major banking market in the EC, containing large, domestic, often state-owned institutions. The three largest banks are all owned by the government. The next three largest were only recently privatized. In 1987, the 5 largest banks in France controlled nearly 80 percent of total banking assets in France, representing over half of the entire financial system. This extent of concentration leads some analysts to believe that short of outright acquisition, the large French banks' domestic position is impregnable.

Some Impediments May Remain, While Others Will Only Slowly Disappear

As explained in chapter 1, the Single Market Program, by the EC's own design, does not standardize all EC regulations for financial firms and markets. Rather, the EC's plan is to establish EC-wide minimum essential standards, allowing competitive market forces eventually to bring about an equilibrium level of harmonization. The interim result may be a slow, sometimes uneven, integration process. This process could, in some instances, work to the disadvantage of U.S. firms. Some member states may not remove some barriers for a while in order to protect domestic firms or to ensure safety and soundness.

Officials said that the EC's 1992 program does not eliminate member state restrictions on the types of foreign investment products that domestic firms may invest in or on the types of products that may be

[13]Under the Second Banking Directive, an EC bank's ownership in stock of any nonfinancial firm is limited to 15 percent of bank capital and 60 percent in aggregate. West Germany, however, is opposed to this restriction, which could force divestitures by German banks.

[14]Government debt in West Germany is sold via a consortium rather than a free auction system, as used in the United States.

sold. For example, West German insurance companies, the largest institutional investors in Germany, are prohibited from investing the majority of their assets in foreign investment products.[15] Insurance companies in Germany, foreign and domestic, are also restricted in the types of products they can sell. For example, certain types of insurance that are sold in the United States and for which U.S. insurers have developed a market edge, such as cancer insurance or corporate officers' and directors' liability insurance, cannot be sold in West Germany.

Business Considerations

While not discriminatory, there are certain "natural" advantages enjoyed by domestic institutions in their home markets that act as barriers to foreign firms. The barriers that U.S. financial firms encounter affect their strategic planning for new market entry or expansion. Among the advantages naturally accruing to domestic institutions are the loyalties and cultural links with domestic customers, familiarity with the local language, and knowledge of legal and regulatory norms. These ties are especially important in retail markets. For example, a domestic bank's easier access to retail deposits can result in a lower cost of funds than is available to foreign banks, which typically rely on more expensive interbank loans. A U.S. bank manager in Spain said that U.S. banks also have a difficult time attracting qualified personnel.

Other Factors Influence U.S. Financial Firms' Strategies

In tandem with 1992 developments, a number of international market and regulatory trends are also occurring that could affect U.S. financial firms' participation in the EC. For banks, the Basle Committee's new capital adequacy standards, less developed country debt burdens, and new market opportunities opening in the United States affect their strategies. Greater competition and increasing trends toward market specialization are other factors that affect the strategies of all financial firms, including banks.

[15]Similar restrictions apply to Italian life insurance companies and to French mutual funds, called SICAVS.

New Capital Adequacy Requirements Raise Bank Costs

The world's major banks, including those from the United States, are bound to adhere to a minimum standardized capital adequacy ratio beginning in 1991.[16] Many banks do not meet this minimum ratio and, therefore, may have to raise more capital or reduce their assets, or both. Those banks under most pressure to meet capital adequacy guidelines are being forced to sell off portions of their organization to raise capital and reduce their asset base. Cutbacks have already occurred in U.S. banks' EC retail operations, which tend to require large amounts of fixed capital. Raising new capital has been hampered by U.S. bank stocks' poor performance in recent years. U.S. money center banks' earnings have lagged behind both regional banks' and the Standard & Poor's 500 stocks' earnings. Because bank stocks have become a less desirable investment, it is more difficult for these banks to raise needed capital. These concerns may lead even relatively healthy U.S. banks to be more cautious in approaching new and unproven markets or activities.

Less Developed Country Debt Problems Have Reduced Banks' Profitability

U.S. banks' profitability, especially the earnings of international money center banks, is being reduced by increased loan loss provisions on less developed country loans made during the 1970s. Banks' exposure to these loans has raised their cost of capital by reducing stock market valuations. This exposure has also expended key management resources, has possibly made management more wary and cautious of new ventures, and has cut into banks' profit because of the need to set aside specific reserves. Some U.S. banks are substantially increasing their reserves for these loans, but doing so requires capital that might otherwise have been used to expand in the EC. Meanwhile, EC banks have not suffered as greatly from less developed country loan problems. According to a U.S. consultant, EC banks had the strength of their retail bank profits to cover their reserves. In addition, different requirements for set-aside reserves in some EC countries, notably West Germany, encouraged early action on these loans.

Domestic Opportunities Compete for Attention and Funding

U.S. banks told us that the EC is not the only investment alternative available to them. Many of the U.S. international money center and regional bank officials we interviewed are targeting their capital resources toward new domestic opportunities where they expect returns

[16]Under the 1988 Basle Convergence Agreement, the Group of Ten (G-10) countries, actually constituting 11 countries, including Belgium, Canada, France, Italy, Japan, Luxembourg, the Netherlands, Sweden, the United Kingdom, the United States, and West Germany, have agreed to a standardized formula for calculating capital ratios of banks. Beginning in 1991, banks should have a minimum capital base of 7.25 percent of risk-adjusted assets. In 1993, the minimum ratio increases to 8 percent.

on investment will be greater. The resolution of the savings and loan crisis will allow banks to diversify and to expand by buying failed thrifts at distressed prices. Interstate barriers are falling in many states, providing opportunities for U.S. banks to expand to other parts of the United States. Indeed, the anticipated expiration in 1992 of interstate branching restrictions in California may offer greater opportunities than does the EC. In addition, representatives of some insurance companies and banks told us that the Far East offers more attractive investment opportunities than those available in the Community.

Increased Competition in the EC Is Expected

As a result of the EC's Single Market Program, increased competition, both from EC and non-EC financial firms, is expected by most U.S. financial firms, consultants, and experts with whom we spoke. Deregulation should, as a matter of course, lead to greater competition among financial institutions. EC financial firms are expected to meet those competitive challenges not only by expanding their presence in other EC countries, but also by becoming more competitive at home to ensure their customer base. Expansion by EC financial firms across borders and into other market sectors is a natural outgrowth of the enlargement of the EC's marketplace from national boundaries to EC boundaries. Expansion is generally taking one of two routes: directly through merger or acquisition, or indirectly via strategic alliances. At the beginning of the Single Market Program (1984-1987) there was a notable increase in the number of EC mergers, minority acquisitions, and joint ventures in the banking sector. For example, the number of bank mergers nearly doubled, from 18 to 35, during this period. Because the number of attractive acquisition candidates is limited, financial firms in the EC are also looking to build cross-border alliances. Alliances allow firms to expand their product distribution without a significant loss of managerial control.

Increased competition from other non-EC countries, notably Japan, is also anticipated as 1992 approaches. Leading Japanese institutions have been established in London for some time. Japanese financial institutions have also established banking affiliates in Frankfurt to gain a foothold in the important Deutsche mark sector. U.S. regulatory authorities now anticipate that the Japanese will relax restrictions on the overseas securities activities of their banks.[17] If so, the United States will be the

[17]Current restrictions on the securities activities of Japanese banks are detailed under article 65 of Japanese banking law. Experts say its provisions separating banking and commerce are broadly similar to those in the U.S.' Glass-Steagall Act.

last major financial power to retain this separation of commercial and investment banking. Furthermore, increased demand for financing from the Japanese manufacturing sector in Europe, which is actively expanding in the EC prior to 1992, will undoubtedly mean increased business for Japanese financial firms.

Financial Firms Are Wary, Following the U.K.'s "Big Bang"

The deregulation of the U.K.'s financial markets in 1986, often referred to as the "Big Bang," led to intense competition there. As a result, many segments of the U.K.'s market quickly became saturated. For example, in the U.K.'s equities market, the number of market-makers (dealers) rose from 5 before the Big Bang to 32 not long after. The market decline in October 1987 contributed to these firms' losses. Therefore, U.S. financial firms may be wary about entering new markets with a large financial commitment, especially when intense competition is expected.

Conclusions

The EC's progress in liberalizing its markets under the Single Market Program has provided ample evidence to the international financial community that a single market in Europe is likely to emerge. Estimating how it may affect the U.S. financial services industry this early in the process is, nevertheless, very difficult. Some key EC financial services directives still require final passage. Additional directives, notably in the insurance sector, will have to be proposed and adopted in order to achieve a fully liberalized and integrated market. Even once all the directives are finalized, much will still depend on how the member states implement them. And, finally, the directives by themselves will not dictate the final form of post-1992 EC financial markets; internal and external economic, political, and technological variables will also weigh heavily on the process and its result.

This report has tried to identify the most likely impact of the Single Market Program on U.S. financial firms in Europe. The evidence and our analysis strongly indicate that the sizable stake U.S. financial firms have built in the EC will not be jeopardized by overt EC actions to bar them. Nor is the EC likely to restrict the future entry of other U.S. financial firms not already there. Therefore, U.S. firms should benefit from the new and expanded opportunities offered by the single market.

Equal access and expanded opportunities alone, however, may not be enough to ensure that U.S. financial institutions will prosper in a post-1992 Community. This is especially true for U.S. banks, which have the greatest stake in the EC among U.S. financial firms, but are also facing

the greatest challenges. During the 1980s, U.S. banks have seen their global dominance fade for several reasons, such as poor international lending practices and the competition posed by nonbank financial institutions.

The evolving divergence between U.S. and EC regulatory philosophies now poses an additional challenge to U.S. banks that operate in the Community. EC banks are organized under a regulatory structure that allows them to compete better and to profit more easily from broader powers under the Single Market Program. U.S. banks, by contrast, remain governed by a regulatory philosophy that prohibits universal banking. These regulatory developments under the Single Market Program are occurring against the backdrop of fundamental shifts in corporate and investment finance away from the traditional activities permitted U.S. banks and toward those that are still impermissible or restricted. As a result, U.S. banks are likely to face larger, better capitalized, and more diverse EC universal banks armed with broader powers and capabilities under the Single Market Program.

Matters for Congressional Consideration

The EC's endorsement of the universal banking model for its more open financial markets gives greater urgency to the ongoing congressional debate over how broad U.S. bank powers should be. The decision to modify the existing requirements is a judgmental one. In weighing the pros and cons of the existing structure, consideration should be given to the impact of these requirements on the ability of U.S. banks to compete in the EC after 1992.

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The Appropriateness of the U.S. Government's Response

Generally, the U.S. government has responded in a timely and cooperative fashion to protect U.S. financial sector interests in the emerging EC single market. U.S. agencies organized early to identify the primary issues and to develop a coordinated policy response. Reciprocity served as the primary test of the adequacy of the U.S. government's ability to defend U.S. interests and, while U.S. intervention was not the only factor, it helped to soften the EC's stance. U.S. financial firms generally view the U.S. government's efforts favorably.

Many U.S. Government Agencies and Private Sector Groups Are Monitoring the EC's 1992 Program

Numerous U.S. agencies and private sector groups have an active interest in the EC's program to integrate its financial markets. The U.S. Treasury Department is responsible for forming policy and monitoring, assessing, and directing the U.S. government's response to the EC's 1992 financial services directives, including banking and securities issues, as well as for monitoring the general macroeconomic implications for the United States of the EC's program. Treasury representatives stated that they keep the other agencies informed of developments and consult them when necessary, but they are primarily responsible for responding to 1992 financial sector developments.

Within Treasury, the Office of Assistant Secretary for International Affairs is most active in directing Treasury's efforts. Treasury relies on its financial attaches located in London, Bonn, Paris, and Rome to report and to disseminate information. In the other U.S. embassies and missions in EC member countries not staffed with an attache, Treasury relies on Department of State personnel to perform the same activities.

Many other agencies and private sector groups are also involved in monitoring developments in the EC's financial sector, including the Department of Commerce, the U.S. International Trade Commission, the Office of the U.S. Trade Representative, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, and the Congressional Research Service.

These U.S. government agencies have also enlisted the support of private sector associations and groups with an interest in European financial markets. These groups include the Bankers Association for Foreign Trade, the American Bankers Association, the Investment Companies Institute, the International Insurance Council, the Industry Sector Advisory Committee, the National Association of Securities Dealers, the Business Roundtable Task Force, and the U.S. Chamber of Commerce, along

with various American Chambers of Commerce throughout the Community.

U.S. Policy Coordination

The U.S. government is coordinating its overall efforts on EC single market issues through the Trade Policy Review Group's EC Internal Market Task Force. This task force, formed in February of 1988, is a committee of 15 executive branch agency representatives chaired by the Office of the U.S. Trade Representative. It reports directly to the cabinet-level Economic Policy Council. The task force is divided into 10 functional working groups and has 3 main objectives: (1) to understand the nature of the EC's 1992 program and the directives proposed to implement it; (2) to keep the U.S. government current on events as they occur; and (3) to identify and address potential problem areas. Treasury has not participated at the working group level, but does represent banking and investment issues at task force meetings and coordinates regularly with the relevant task force members.

Seeing a need for coordination specific to financial services issues, the Secretary of the Treasury established a subcabinet level group in September 1989, called the Policy Group on European Monetary Reform and Financial Liberalization. Chaired by the Under Secretary for International Affairs, it includes the Departments of State and Commerce and the Office of the U.S. Trade Representative, with the Federal Reserve Board, the Securities and Exchange Commission, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and other financial regulators serving in an advisory capacity. According to a senior Treasury official, the group is both devising a strategy for dealing with the EC's financial market integration and focusing on the structure and competitiveness of the U.S.' financial industry. The group will also report on the broad implications for the United States of EC efforts toward economic and monetary union.

Overseas U.S. Government Agencies Are Active in the EC

While U.S. policy for responding to the EC is formulated in Washington, D.C., the front lines of action are the U.S. embassies and missions in the EC, in particular the U.S. Mission to the European Community in Brussels, Belgium. These embassies and missions are responsible for information gathering, reporting, and implementing U.S. policy. Agency headquarters direct embassy and Mission officials to collect views and information as well as to lobby on behalf of American interests.

For EC-related matters, the U.S. Mission to the European Community is the focal point for U.S. government activities. The Mission represents, reports to, and acts on behalf of many different agencies with interests in the EC. For financial services, the Mission reports to and represents the interests of the Treasury, Commerce, Federal Reserve, U.S. Trade Representative, and Securities and Exchange Commission. Even though the Mission is relatively small compared to the EC, and its position is that of an outsider, numerous U.S. government officials stated that it has been very useful and serves as a crucial conduit for U.S. policy.

The Mission is staffed by an ambassador and 23 Department of State, Agriculture, and Office of the U.S. Trade Representative officials.[1] A single State officer monitors EC financial services and monetary issues, with the assistance of a local national economic specialist. State has been criticized by some Members of Congress for not adding more and diverse staff to the Mission in light of its growing importance and responsibilities. In reply, State argues that additional staff at the Mission—already one of the larger U.S. Missions—may not be cost-effective in light of current budget constraints, but it has agreed to add one middle-level officer and possibly more in the future to help with the increasing work load. The Mission was also criticized for not staffing a Treasury financial attache to handle financial services. Mission officials counter that it is more important to act as an integrated unit and that semiautonomous agency personnel might hamper that coordination. Treasury was satisfied with the current arrangement at the Mission and believed it was doing a good job handling financial services issues related to EC 1992. While we did not evaluate either the adequacy or appropriateness of the Mission's staffing, our general impression was that both the former and the current Mission foreign service officers responsible for financial services were well informed and capable.

In addition to the U.S. Mission to the EC, American interests in the Community are represented by U.S. embassies in the 12 member states. Some public and private sector officials stated that lobbying member state governments is as important as, or perhaps more important than, lobbying the EC Commission. This view is based on the fact that the EC—a collection of 12 separate countries—requires a qualified majority of

[1] As of June 1989, this staff includes a deputy chief of mission; seven economics officers, one of whom is responsible for the financial services sector; seven political officers, including a single market coordinator; five agricultural officers; two public affairs officers; and a customs attache.

member states, and sometimes full unanimity, to pass legislation. Individually influencing member states, some believe, can be more successful than attempting to influence the unelected Commission.

Finally, American interests are also represented in other multinational arena, such as the U.S. Missions to the Organization of Economic Cooperation and Development (OECD), the General Agreement on Tariffs and Trade (GATT), and the annual economic summits of G-7[2] leaders. These U.S. Missions to the OECD and the GATT, which also monitor financial sector developments, coordinate with the U.S. Mission to the EC on EC-related matters.

The U.S. Government Provided an Early and Coordinated Response

While the rapidity with which the EC has moved on its 1992 program has surprised many, even some members of the Commission, the U.S. government was able to monitor events and coordinate its various agencies in most cases to act swiftly enough to protect U.S. interests. The EC's inclusion of reciprocity as part of its financial services framework has provided, thus far, the greatest threat to U.S. interests and thereby has tested the effectiveness of the U.S. government's ability to protect those interests. And while the U.S. government's response was one factor among many influencing the EC to modify its stance on reciprocity, the revision is much more favorable to U.S. financial firms and the U.S. government. U.S. financial firms operating in the EC generally view favorably the manner in which the U.S. government acted. The exception we noted was that this coordination was not as evident regarding EC actions affecting the insurance sector. Despite the passage of the White Paper in 1985 and the Single European Act in 1987, it was not until the EC surmounted budget disagreements in early 1988 that progress on the Single Market Program accelerated. Shortly thereafter, in March 1988, the U.S. Mission to the EC reported potential issues of concern in a series of seven cables to headquarters agencies. One of these cables highlighted potential problems for U.S. financial firms.

Given the numerous U.S. agencies involved in EC single market issues and the magnitude of these issues, the need for coordination is self-evident. In August 1988, the Trade Policy Review Group's EC Internal Market Task Force issued general policy guidance to interested agencies

[2]The Group of Seven (G-7), which includes the United States, France, Japan, West Germany, the United Kingdom, Canada and Italy, convenes at the annual economic summit, where the nations are usually represented by their finance ministers or central bankers.

and overseas posts identifying the major EC 1992 concerns and the manner in which the U.S. should respond to them. During the same period, the Deputy Secretary of the Treasury delivered a major address highlighting U.S. government concerns, and he also contacted the finance ministers of all the EC member states. In October 1988, Treasury officials visited the European Community in Brussels to voice their concerns regarding some aspects of the financial services directives.

U.S. Policy

The U.S. government sent general guidance that speaking with a single voice, or common line, is the most effective way to communicate U.S. concerns to the EC and that all communications, including public statements and private communications with the EC and member states, should adhere to this common line. In this way, the U.S. government emphasized major U.S. policy positions in its discussions with the EC and member states and minimized conflicting signals.

This guidance also emphasizes the importance of systematic lobbying of EC member states through U.S. embassies and the U.S. Mission to the OECD. The U.S. embassies and missions keep up with EC developments, collect member state views, and communicate elements of the U.S.' common line on EC matters. Ample evidence of these activities was found in regular cable traffic at the U.S. Mission to the EC, U.S. embassies in Europe, and the Department of State.

U.S.-EC interaction takes place at two levels: a dialogue between high-ranking officials, and a working level of contacts among specialists. The uppermost level of U.S.-EC communication begins with ad hoc meetings between the U.S. President and the President of the Commission.[3] It continues with ad hoc and formal ministerial level meetings between the U.S. Secretaries of State and Treasury and the U.S. Trade Representative and its European counterparts; ambassadorial contacts in member state countries; and regular subcabinet level and assistant secretary level meetings with EC officials.

At the working level, U.S. officers in the U.S. Mission to the EC, other overseas posts, and Washington agencies maintain a regular dialogue with their working level contacts in Brussels, host member states, through OECD meetings, and the EC delegation in Washington. These contacts are extremely important for early monitoring of EC developments and for influencing draft legislation.

[3]In 1989, Presidents George Bush and Jacques Delors met twice.

The U.S. government also recognizes the importance of involving the U.S. private sector in communicating U.S. interests. Private sector involvement not only allows for an early exchange of information, which benefits both the U.S. government and the private sector, but also adds another channel for communicating U.S. concerns to the EC. The American Chamber of Commerce's EC Committee in Brussels is among the best examples of this private sector activism. This committee analyzes and comments on draft EC legislation and regularly lobbies the EC on behalf of U.S. interests. Treasury asked the Bankers Association for Foreign Trade to organize and to represent the views of U.S. international banks to the Community. In April 1989, the Association released a paper highly critical of the EC's approach to reciprocity.

Gap in U.S. Government Coordination for Insurance Issues

The sole exception we found to the United States' providing an effective framework for responding to EC financial services initiatives is in the area of insurance. Perhaps owing to their relatively small presence in the Community and the lack of a federal insurance regulator, insurance matters have not been a priority of the U.S. government. The Department of Commerce claims responsibility for insurance matters in the EC, but its activities thus far have been primarily informational. Treasury, although not responsible for the insurance sector, has been monitoring insurance directives in terms of their relationship to other financial services directives.

Commerce's Foreign Commercial Service aids U.S. insurers in establishing their businesses and instructs them on local business practices but does not monitor issues dealing with regulatory treatment.

Reciprocity Tested the Effectiveness of U.S. Government Policy and Coordination

The first and, thus far, greatest test of the U.S. government's coordinated policy for protecting American interests came with the EC's inclusion of a restrictive reciprocity provision in an early version of the Second Banking Directive. The U.S. government employed all facets of its coordinated policy approach in successfully lobbying the EC to liberalize these provisions. While it is impossible to quantify or to isolate the effect U.S. government efforts had in relation to other factors—such as the change in EC leadership, member state objections, and internal and external private sector efforts—the end result is a less restrictive form of reciprocity that should preserve access for U.S. financial firms to EC markets.

Arguments Employed by the U.S. Government Before the EC

The position espoused by the U.S. government in fighting the inclusion of reciprocity in EC directives is based on a number of precepts and arguments. The most fundamental argument has been the threat reciprocity poses for continued free trade among nations. Treasury cautioned the Commission that using reciprocity as a tool to fight protectionism by other countries would only encourage a trade war among financial markets, affecting not just the individual countries involved, but also the world's financial system.

Treasury also reminded the EC that adherence to mirror-image reciprocity would undermine the single market's commitment to a free and open market. Denying U.S. firms' access to the Community could generate protectionist pressures against EC firms in the United States, an obvious concern to those EC countries with a sizable stake in U.S. financial markets.

Treasury also argued that the practical implementation of reciprocity is overly burdensome. Reciprocity was abandoned in the United States because it would have required multiple rules and regulations specific to each of the more than 60 countries that operate banks in the United States, all based on the treatment of U.S. banks located in over 70 countries.

EC and member state officials were also cautioned by the U.S. government that the EC's reciprocity provisions run counter to EC and member state obligations under bilateral treaties of Friendship, Commerce, and Navigation, the OECD's Code of Liberalization of Capital Movements, and the EC's own Treaty of Rome. The United States maintains that EC member states would violate such outstanding treaties between the United States and most EC member states were reciprocity to be invoked against U.S. firms. Under these treaties, U.S. companies are entitled to national treatment.

The OECD's Code of Liberalization for Capital Movements is an agreement among all OECD member states to gradually eliminate barriers to capital movements. While the EC is not a signatory to this code, its member states are. State Department officials stated that any reciprocity provisions imposed by the EC could put member states in violation of several of the code's provisions. In September 1988, the OECD Secretariat found the EC's proposed use of reciprocity violates this code.

The U.S. government has taken the position that denying access to U.S.-owned, but EC-incorporated, subsidiaries also violates the EC's own

treaty obligations. Under article 58 of the EC's Treaty of Rome, "Companies or firms formed in accordance with the law of a member state and having their registered office, central administration, or principal place of business within the community shall ... be treated in the same way as natural persons who are nationals of member states." U.S. government officials interpret this statement to mean that U.S. firms incorporated in the EC should be assured access to the EC, regardless of the access or powers afforded EC firms in the U.S.

Private Sector Views of U.S. Government Response

U.S. financial firms with a presence in the EC generally stated that the U.S. government responded in a timely and effective manner to their concerns about the EC's single market program. This view is based primarily on their initial concerns over the EC's stance on reciprocity and the belief that the U.S. government response was an influence in liberalizing that provision. As noted in the prior chapter, most of the U.S. financial firms that we interviewed felt confident the revised reciprocity clause would not threaten their ability to enter the EC market and enjoy the benefits of the single market. However, these firms warn that the U.S. government must continue to track the reciprocity provision and other EC initiatives affecting U.S. interests, and they urge the United States to remain vigilant in defending their interests.

U.S. financial firms vary widely in their degree of knowledge concerning single market initiatives. Private sector associations lobby the EC to promote their interests, and some U.S. financial firms also lobby their interests directly before the EC. These firms complimented the U.S. government's response most highly.

Future Concerns and the Framework for Response

Generally, responsible U.S. government agency officials view favorably the EC's efforts to liberalize its financial markets. However, while the primary concern over reciprocity has largely abated, these officials believe it is important to look to the future and assess what new issues may emerge and to ensure that the U.S. government is poised to react.

Emerging Concerns

Based on our discussions with U.S. financial firms and government officials, there are a few EC initiatives underway that could put U.S. financial firms at a disadvantage and that, therefore, bear close scrutiny. Among these concerns are the possible reemergence of reciprocity in

other directives; the present delays in the implementation of the Investment Services Directive; the lagging liberalization of the insurance sector; and the broader impact of the European Monetary Union.

Ongoing Concerns About EC Reciprocity Proposals

While the apprehension by U.S. officials and private sector industry groups about the reciprocity provision in article 9 of the Second Banking Directive has largely subsided, U.S. agencies and regulators remain cautious. These officials are dismayed that a reciprocity concept is still being embraced by the Community, albeit in a milder form. Access to the EC market is still based on U.S. treatment of EC firms, under which the EC may negotiate with the United States if it does not offer, in the EC's view, effective market access and competitive opportunities comparable to those granted by the Community to non-EC banks. While the immediate practical effect of this provision may be limited, the precedent this sets for the global financial services industry nevertheless disturbs U.S. officials.

The use of reciprocity, as espoused by the EC, versus the standard of national treatment (or equality of competitive opportunity), as applied in the United States, are competing concepts within the current GATT negotiations. Outstanding GATT agreements do not cover financial services, but they are among the primary topics under the current round of GATT multilateral trade negotiations, referred to as the Uruguay Round, slated for conclusion at the end of 1990. Within the Uruguay Round, the U.S.' position is that financial services should be based upon the principle of national treatment. The EC has proposed a different approach in GATT negotiations, based on the "effective market access" principle. This concept presumes that national treatment alone is not enough to permit market penetration, especially if national treatment co-exists in a restrictive and highly regulated environment. The United States fears that the EC's position would restrict the liberalization of world financial markets.

Furthermore, the possibility still exists that a stricter reciprocity provision could be included in the Investment Services Directive or in the Life and Non-Life Insurance Directives. While EC assurances are that the more liberal reciprocity provision in the Second Banking Directive will be copied for these other directives, changes in U.S.-EC relations, or more protectionist elements in the EC, could alter these intentions.

Problems Caused by Delays in the Investment Services Directive

The EC has stated that the banking and investment services directives will not only be parallel in design but also will be implemented simultaneously, so as not to create an "unlevel" playing field between banks and investment services firms. However, while the banking directive has been adopted and is on schedule for implementation on January 1, 1993, the Investment Services Directive is much further behind, with a number of hurdles yet to jump. Some U.S. securities firms in London are especially troubled by the possibility that the Second Banking Directive might be implemented before the Investment Services Directive. In that event, firms that conduct only investment services would not have the single passport power to branch freely and to offer services across borders. They would, therefore, be at a competitive disadvantage to banks, which could use their single passport to conduct investment services under the banking directive. U.S. securities firms (and some British merchant banks) would be notably disadvantaged by this inequity, since investment services in most other EC countries are offered primarily by banks, which would not suffer from any delays in the implementation of the Investment Services Directive. This latter fact leads some to believe that these countries will not be eager to move quickly on the Investment Services Directive.

The EC's Insurance Sector Liberalization Is Lagging

The liberalization of the EC's insurance sector lags behind that of the banking and securities markets. The EC is further away from agreeing on a single license for the offering of insurance services than for the other financial sectors, partly because of national tendencies toward protecting domestic insurance industries. These delays trouble U.S. government and private sector officials because of the significant opportunities they foresee should the insurance sector be liberalized.

European Monetary Union

The EC's program to create a unified financial market by 1993 is only a step toward greater European Monetary Union. The leaders of the EC reaffirmed their movement toward this goal in July 1989, entering into the first of three stages towards implementing monetary union. Such a union could have a considerable impact on U.S. monetary policy and on the global economic system. Progress in achieving such a union is, therefore, of keen interest to some U.S. government officials monitoring EC actions.

U.S. Government Strategy for the Future

As the EC's Single Market Program for financial services evolves, the U.S. government will continue to use the framework and policy explained earlier in this chapter, primarily through Treasury's Policy Group on European Monetary Reform and Financial Liberalization.

In addition, Treasury has begun work on a 1990 National Treatment Study, which will include a first-time assessment of the EC's treatment of U.S. banks and securities firms. This study is due to Congress by December 1, 1990.

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Status of Single Market Program Legislation

The listing below represents the status (to January 1990) of the primary legislative steps necessary to the completion of a single market for financial services outlined in the EC Commission's White Paper of June 1985, "Completing the Internal Market." This does not represent an all-inclusive list of EC financial services legislation.

Banking

Council Directive on the accounts and consolidated accounts of banks and other financial institutions
Adopted by EC Council: December 8, 1986
This directive intends to harmonize consolidated accounting practices for banks, including their format, nomenclature, and terminology for their accounting documents.

Council Directive on the obligations of branches established in a member state by credit institutions and financial institutions, having their head offices outside that member state, regarding the publication of annual accounting documents
Adopted by EC Council: February 2, 1989
This directive establishes the sufficiency of consolidated accounting documents, and the accounting information required within the documents, for branches of banks from other countries. It effectively eliminates the requirement for publication of separate annual accounting documents for each branch.

Proposal for a Directive on the freedom of establishment and the freedom to supply services in the field of mortgage credit
Planned adoption by EC Council: 1990
This proposed directive would allow credit institutions to grant mortgage credit secured by real property situated anywhere in the Community.

Proposal for a Directive on the coordination of laws, regulations, and administrative provisions relating to the reorganization and dissolution of credit institutions
Planned adoption by EC Council: 1990
This proposed directive coordinates the practices for the dissolution of credit institutions. The institution's home country would have primary jurisdiction and apply its law throughout the Community.

Council Directive on the own funds of credit institutions
Adopted by EC Council: April 17, 1989
This directive establishes Communitywide standards for own funds

(capital) of credit institutions. Own funds constitute the numerator for the solvency ratio, which is the subject of a separate Council directive.

Commission Recommendation concerning the introduction of deposit-guarantee schemes in the community
Adoption by EC Council: not necessary for recommendation
This recommendation suggests that those member states that do not have a deposit guarantee scheme draw up a scheme according to prescribed conditions. This recommendation supplements a proposed directive [COM (85) 788] that requires each member state to cover the depositors of all authorized credit institutions, including depositors of branches of credit institutions that have their head offices in another member state. Until such time as all member states have a scheme, those member states with a scheme will be required to cover their branches in other member states. A directive has been proposed to replace this recommendation.

Commission Recommendation on monitoring and controlling large exposures of credit institutions
Adoption by EC Council: not necessary for recommendation
This recommendation attempts to protect depositors by recommending that member states require institutions to report large or excessive exposure concentrations to a single client or group of clients. A directive has been proposed to replace this recommendation.

Second Council Directive on the coordination of laws, regulations, and administrative provisions relating to the establishment and pursuit of the business of credit institutions and amending Directive 77/780/EEC
Adopted by EC Council: December 15, 1989
The Second Banking Directive is key to the single market for financial services. The directive grants a single banking license to authorized credit institutions to freely branch or offer services across EC borders. Prudential supervision of each institution is governed by the home country of authorization.

Securities

Council Directive on the coordination of laws, regulations, and administrative provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS)
Adopted by EC Council: December 20, 1985
This directive harmonizes member state laws pertaining to UCITS (similar to open-ended mutual funds in the United States) and allows their marketing on a Communitywide basis.

Council Directive amending, as far as concerns the investment policy of certain Undertakings for Collective Investments in Transferrable Securities, Directive 85/611/EEC
Adopted by EC Council: March 22, 1988
This directive liberalizes requirements for the investment in UCITS issued by the same issuer and specifies certain fiduciary responsibilities for the supervision and safekeeping of assets.

Council Directive on the information to be published when major holdings in the capital of a listed company are acquired or divested
Adopted by EC Council: December 12, 1988
This directive harmonizes reporting and disclosure requirements, especially regarding takeover attempts, for companies whose shares are listed on an official Community stock exchange.

Council Directive on the coordination of the requirements for the drawing-up, scrutiny, and distribution of the prospectus to be published when securities are offered to the public
Adopted by EC Council: April 17, 1989
This directive provides minimum essential standards for the contents of a prospectus of newly offered securities (both on and off exchange).

Insurance

Second Council Directive on the coordination of laws, regulations, and administrative provisions relating to direct insurance other than life insurance, laying down provisions to facilitate the effective exercise of freedom to provide services
Adopted by EC Council: 6/22/88
This directive amends the First Council Directive for non-life insurance by liberalizing cross-border insurance services for large commercial and industrial risks. This directive also provides for home country control for large risk insurance.

Council Directive on the coordination of laws, regulations, and administrative provisions relating to legal expenses insurance
Adopted by EC Council: June 22, 1987
This directive harmonizes member state requirements for insurance against legal expenses.

Council Directive amending, as regards credit insurance and suretyship insurance, the First Directive 73/239/EEC
Adopted by EC Council: 6/22/87
This directive amends the First Council Directive (DIR 73/239/EEC)

with regard to credit insurance by requiring firms that offer credit insurance to establish equalization reserves.

Proposal for a Council Directive on the coordination of laws, regulations, and administrative provisions relating to insurance contracts
Planned adoption by EC Council: 1990
This proposed directive harmonizes and sets minimum standards for the laws, regulations, and provisions for non-life insurance contracts.

Proposal for a Council Directive on the coordination of laws, regulations, and administrative provisions relating to the compulsory dissolution of direct insurance undertakings
Planned adoption by EC Council: 1990
This proposed directive seeks to harmonize member states' treatment of insurance contracts in the event of an insurance company's dissolution.

Proposal for a Council Directive on the annual accounts and consolidated accounts of insurance undertakings
Planned adoption by EC Council: 1990
This proposed directive seeks to harmonize the financial reporting standards of community insurance companies.

Proposal for a third Council Directive on the approximation of the laws of the member states relating to insurance against civil liability in respect to the use of motor vehicles
Planned adoption by EC Council: 1990
This proposed directive seeks Communitywide, compulsory third-party liability motor vehicle insurance.

Proposal for a Council Directive amending, particularly as regards motor vehicle insurance, DIR 73/239/EEC and DIR 88/357/EEC relating to direct insurance other than life insurance
Planned adoption by EC Council: 1991
This proposed directive seeks to allow freedom of services for motor vehicle liability insurance throughout the Community.

Proposal for a second Directive on the coordination of laws, regulations, and administrative provisions relating to direct life insurance, laying down provisions to facilitate the effective exercise of freedom to provide services and amending DIR 79/267/EEC
Planned adoption by EC Council: 1991
This proposed directive seeks to establish the framework for freedom of Communitywide services for the life insurance industry.

Capital Movements

Council Directive, amending the Directive of May 11, 1960, on the implementation of Article 67 of the Treaty of Rome, on the liberalization of units in Undertakings for Collective Investments in Transferable Securities
Adopted by EC Council: December 20, 1985
This directive liberalizes capital movements for transactions involving UCITS.

Additional Financial Services Directives and Proposals

The following legislative steps are not listed in the White Paper timetable but are generally considered to be part of the Single Market Program.

Banking

Council Directive on a solvency ratio for credit institutions
Adopted by EC Council: December 18, 1989
This directive, patterned after the Basle Convergence Agreement, requires that banks maintain their own funds (capital) in a prescribed level to their risk-adjusted assets.

Securities

Council Directive coordinating regulations on insider dealing
Adopted by EC Council: November 13, 1989
This directive harmonizes member state rules against insider trading. The directive prohibits knowingly taking advantage of inside information to buy or sell securities on an exchange market.

Proposal for Council Directive on investment services in the securities field
Planned adoption by EC Council: 1990
This proposed directive parallels the Second Banking Directive and would provide freedom of establishment and services for securities-related activities throughout the Community by authorized investment firms. The authorization and prudential supervision of the investment firm would be provided by the home country.

Proposal for Council Directive, amending Directive 80/390/EEC, in respect of mutual recognition of stock exchange listing particulars
Planned adoption by EC Council: 1990
This proposed directive amends earlier requirements harmonizing the requirements for drawing up and distributing listing particulars and

requires the mutual recognition of other member states' prospectus approvals for entry into any Community exchange.

Capital Movements

Council Directive, amending the Directive of May 11, 1960, on the implementation of article 67 of the Treaty of Rome, liberalizing operations such as transactions in securities not dealt in on an exchange and other capital and securities transactions
Adopted by EC Council: November 17, 1986
This directive lifted exchange controls on direct investment, short- and medium-term trade credits, and some capital and securities transactions.

Council Directive on the liberalization of capital movements
Adopted by EC Council: June 24, 1988
This directive eliminates all remaining capital restrictions in most EC member states by July 1, 1990.

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